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CDS Zombies

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Abstract

This paper examines the contract interpretation strategies adopted by the International Swaps and Derivatives Association (ISDA) for its credit derivatives contracts in the Greek sovereign debt crisis. We argue that the economic function of sovereign credit default swaps (CDS) after Greece is limited and uncertain, partly thanks to ISDA's insistence on textualist interpretation. Contract theory explanations for textualist preferences emphasise either transactional efficiency or

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relational factors, which do not fit ISDA or the derivatives market. We pose an alternative explanation: the embrace of textualism in this case may be a means for ISDA to reconcile the competing political demands from state regulators and its market constituents. We describe categories of contracts susceptible to such political demands, and consider when and why textualism might be the preferred response.

Keywords: CDS, Greece, ISDA, Determinations Committee, restructuring, contracts, textualist, contextualist.

1. INTRODUCTION

On 9 March 2012, the world of finance celebrated the survival of a $3 trillion market against all odds. Seeing market and contract machinery for sovereign credit default swaps (CDS) work precisely as specified when Greece finally moved to restructure its debt must have seemed like a miracle after two years of fear and loathing heaped upon CDS by the press and top public officials.[1] And from the press releases of the International Swaps and Derivatives Association (ISDA) it did indeed seem that all had gone as planned:[2] ISDA's adjudication body promptly declared a 'credit event' under CDS contracts on Greek debt, which triggered an obligation of CDS 'protection sellers' to pay 'protection buyers' for the loss in value on Greek bonds. An auction followed quickly to determine just how much the sellers owed the buyers; the results were in line with the actual losses on the bonds (roughly 79%). Even better, the total net payments due were tiny (under $3 billion) compared to the size of the restructured debt stock ($350 billion), dispelling fears of systemic shock.[3] A Bloomberg headline summed it up: 'Credit Default Swaps Work (See Greece)'.[4] What is not to like?

We are sceptical. Far from revealing a well-oiled machine at work, the March events were a mix of luck and magic, which masked flaws in the contractual and institutional basis of the sovereign CDS market. After Greece, buyers of sovereign

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[1] See, e.g., G. Morgenson, 'Credit Default Swaps as a Scare Tactic in Greece', *New York Times* (19 November 2011).

[2] P. Eavis, 'Debt Insurance in Greece Must Pay Out, Ruling Says', *New York Times*, 9 March 2012 (quoting ISDA General Counsel, Robert Pickel: 'We saw today that the credit default swap market worked.').

[3] Depository Trust & Clearing Corporation, 'DTCC Successfully Completes Greek CDS Restructuring Credit Event Processing' (27 March 2012), available at: <http://www.dtcc.com/news/press/releases/2012/dtcc_successfully_completes_greek_cds.php>.

[4] 'Bloomberg View: Credit Default Swaps Work (See Greece)' (15 March 2012), available at: <http://www.businessweek.com/articles/2012-03-15/bloomberg-view-credit-default-swaps-work-see-greece-eyes-in-the-sky-vs-dot-privacy>.

CDS are left exposed to most kinds of sovereign credit risk. Even for risks that are covered, the likely amount of compensation is anyone's guess. And sovereigns can structure their debt relief operations to affect triggers and payouts on CDS. This outcome follows from a distinct set of contract interpretation strategies deployed by ISDA to save both the CDS market and its own role in this market from government regulators. Having secured breathing space, ISDA may seek reforms to revive sovereign CDS; however, at this writing, the instrument remains something of a zombie.

We look to the Greek CDS episode for clues about the role of trade groups in drafting and adjudicating standardised contracts and, in particular, for how trade group and industry objectives – as distinct from those of the parties – might affect contract interpretation. ISDA's position as the intermediary between one of the biggest financial markets and the most powerful governments in the world may help explain the interpretive choices, and shed light on some of the otherwise puzzling outcomes in its contract adjudication. As part of the task, our paper revisits an old question: what roles do text, context and trade custom play in the interpretation of commercial contracts?[5] The text-context debate in contract theory is relevant because ISDA cites its knowledge of market context in support of its model of private adjudication, yet it chose textualist readings of its contracts at key junctures in the Greek crisis. We consider this apparent disconnect at the end of the paper.

Although we tap into a rich body of work on contract interpretation and trade custom, the contracts in our story are new to this literature. In the derivatives industry, a single ISDA contract form spans a multi-trillion dollar market, where transactions are consummated in seconds. The economic stakes in the interpretation strategy are enormous: uncertainty or error can move billions among parties to standard-form contracts in an instant. Beyond the parties, derivatives contract interpretation can have spillover effects on the financial markets and the broader economy, with implications for interest rates, exchange rates and government finance. Sovereign credit derivatives – the focus of our paper – add the politics of government finance to the mix. When a financial contract stands accused of causing the global financial crisis and threatening the break-up of Europe, the political stakes in its interpretation are huge, quite apart from its micro- and macroeconomic significance.

The drafting and interpretation of these all-important contracts are the province of a single trade group, ISDA. ISDA contracts take a distinctive modular form, which we elaborate in section 3. Different parts are prepared at different times and

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[5] A. Schwartz and R.E. Scott, 'Contract Theory and the Limits of Contract Law', 113 *Yale Law Journal* (2003) p. 541. For a recent review of the literature on incorporating custom into adjudication across different settings, including merchant courts, see J. Blocher, 'Order Without Judges: Customary Adjudication', *Duke Law Journal* (forthcoming 2012).

by different people, but incorporate one another by reference to form a single contract. One such contract might comprise the long-term framework for the parties' relationship, confirmations documenting instantaneous trades, definitions that apply across the market in the products being traded, and collateral arrangements particular to the parties, but not to each trade. Most parts of the contract are defaults; while parties customise on the margins, standardisation is pervasive. For example, an authoritative interpretation of CDS Definitions would directly and immediately apply across the CDS market. ISDA's recently established adjudication procedure for CDS reflects this structure: the Determinations Committees (DCs) do not wade into disputes between individual contract counterparties, but rather issue interpretive rulings at the request of industry members to the industry as a whole. We consider this procedure as an example of private commercial adjudication, but one that contrasts in important respects with the sort contracts scholars have described for other industries.[6]

In some respects, the derivatives industry looks similar to other merchant communities: it is an insular world with its own language and transaction patterns, and an island of private governance in a financial industry heavily regulated by the state. Despite their size, derivatives markets ordinarily operate with considerable informality.[7] Much like the diamond, grain and cotton merchants of yore, derivatives market participants struggle with the challenges of rapid growth and geographic expansion, albeit on a vast scale. A limited number of large repeat players (the dealers) have historically dominated the market and its governance, with smaller, newer and occasional participants only recently winning seats at the table. Even the textualist bend of ISDA Determinations Committees seems consistent with other industries, where scholars describe merchant courts hewing closely to the words on the page even if the parties had ignored them until the dispute broke out.[8]

Comparisons with goods traders and merchant courts soon reach their limits. First, except for a few key commodities, no single market in goods can claim the economic and political significance of derivatives. The effect of ISDA contracts on the world beyond them means that contracting parties' interests and incentives are often at risk of being overshadowed by larger forces. Second, it is hard to adapt essential notions like trade custom to sovereign CDS and ISDA DCs: sovereign

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[6] L. Bernstein, 'Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms', 144 *University of Pennsylvania Law Review* (1996) p. 1765; L. Bernstein, 'The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study', 66 *University of Chicago Law Review* (1999) p. 710.

[7] A. Raskolnikov, 'The Cost of Norms: Tax Effects of Tacit Understandings', 71 *University of Chicago Law Review* (2007) p. 601, at pp. 621-623; *Deutsche Bank AG* v. *AMBAC Credit Products*, LLC, 04 Civ. 5594, 2006 WL 1867497, at pp. 12-14 (S.D.N.Y. 2006).

[8] Bernstein, 'Merchant Court', *supra* n. 6; Bernstein, 'Questionable Empirical Basis', *supra* n. 6.

defaults are tail-risk events that inject politics into commerce; they are the antithesis of routine commercial iterations out of which merchant custom grows. Sovereign CDS contracts are notoriously incomplete, unable to anticipate with specificity the core risks for which they are designed, but the store of practice available to ISDA adjudicators to complete the contracts is scant at best. Third, contract theory explanations for the mix of informal transactions and textualist adjudication do not fit the derivatives industry. In other communities, courts might distinguish between 'relationship-preserving' and 'end-game' norms,[9] but ISDA DCs do not consider individual relationships. They speak to the legal import of contingencies in the outside world to many different relationships at once, some 'end-game', some not.[10] Their textualism may need additional explanation.

In this paper, we begin our search for explanations of ISDA's interpretive strategy. Our case study tracks five shocks to ISDA-drafted CDS contracts from the Greek debt crisis. These came in quick succession over a year, and culminated in the restructuring in March of 2012. Each shock revealed progressively narrower 'risk coverage' flowing from a textualist reading of the CDS contracts.

Section 2 highlights our points of departure in the literature on contract interpretation and trade groups. We describe the relevant ISDA contracts and institutions in section 3. Section 4 sets out the five shocks and the interpretive responses that followed. We conclude with implications for contracts, regulation and industry governance.

2. TEXT, CONTEXT AND TRADE

The debate between 'textualists' and 'contextualists' over contract interpretation goes back decades[11] and intersects with scholarship on dispute resolution and social norms.[12] Noting the essential contours of the text-context debate helps explain why derivatives contracts and ISDA's role are a puzzle.

Textualists argue that courts interpreting commercial contracts should give primacy to contract text, and limit recourse to extrinsic evidence such as pre- and post-contractual words and actions of the parties, and the social context, including industry custom. Their reasoning is usually couched in economic terms, and asso-

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[9] Ibid.

[10] ISDA, Credit Derivatives Determinations Committees Rules (11 July 2011), available at: <http://www.isda.org/credit/docs/DC_Rules_(July-11_2011).pdf>.

[11] For a discussion of the debate, see A. Schwartz and R.E. Scott, 'Contract Interpretation Redux', 119 *Yale Law Journal* (2010) p. 926.

[12] R.C. Ellickson, *Order Without Law: How Neighbors Settle Disputes* (Harvard University Press 1991); Bernstein, 'Merchant Court', *supra* n. 6; Bernstein, 'Questionable Empirical Basis', *supra* n. 6.

ciated with the formalist and neo-formalist streams in legal analysis.[13] The prevailing argument for text over context combines party autonomy and efficiency concerns: merchants should want courts to rely as much as possible on the plain meaning of the contract text so as to minimise incentives for opportunistic behaviour ex post and thereby encourage efficient investment ex ante. If excluding extrinsic evidence occasionally causes a court to misidentify the true intent of the parties, merchants should still prefer textualism so long as they win about as much as they lose from court errors over time: the benefit of deterring opportunism is worth it. In this view, courts do and should help police the boundary between the informal domain of transactions and 'relationship-preserving norms', and the formal domain of adjudication and 'end-game norms', which the parties enter only after abandoning efforts to save their relationship. Contract text is written for the end-game, and merits special deference as a result.

When they describe adjudication in their industry, at least some merchants appear to side with the textualists. This merchant testimony also supports a statutory critique and an institutional competence argument: when business people cannot rely on commercial codes and public courts to respect their contract text, they will opt out of the public legal system in favour of private industry rules and tribunals.[14]

Contextualists, in contrast, stress the primacy of the contracting parties' socially embedded meaning in any given dispute.[15] Their roots are in legal realism and the later literature on relational contracting.[16] US scholars on all sides of the debate usually cite the Uniform Commercial Code (UCC) – with its call to find the parties' agreement in 'the language used by them and … their action, read and interpreted in the light of commercial practices and other surrounding circumstances'[17] – as the apotheosis of contextualism. Where textualists seek to fix drafting and negotiating incentives on average to achieve an efficient stream of transactions, contextualists

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13 See, e.g., Symposium 'Formalism Revisited: Formalism in Commercial Law', at pp. 527, 710-859.

14 Bernstein, 'Merchant Court', *supra* n. 6; Bernstein, 'Questionable Empirical Basis', *supra* n. 6; L. Bernstein, 'Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry', 21 *Journal of Legal Studies* (1992) p. 115.

15 See, for example, Uniform Commercial Code, Art. 1-303, 2-208 (on the respective roles of course of performance, course of dealing, and usage of trade in contract interpretation).

16 S. Macaulay, 'Non-Contractual Relations in Business: A Preliminary Study', 28 *American Sociological Review* (1963) p. 55; S. Macaulay, 'The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules', 66 *Modern Law Review* (2003) p. 44; I.R. Macneil, 'The Many Futures of Contracts', 47 *Southern California Law Review* (1974) p. 691; I.R. Macneil, 'Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law', 72 *Northwestern University Law Review* (1978) p. 854. For an overview, see Symposium 'Relational Contract Theory: Unanswered Questions', 94 *Northwestern University Law Review* (2000).

17 Uniform Commercial Code, Art. 1-303, Official Comment 1; see also ibid, Art. 1-201(3).

might import the parties' evolving relationship and its thick social context into the court's reading of the text … or might abandon the text altogether. Where textualists see a bright line between relational commerce and formal disputes, contextualists see seamless continuity. Thus a full-blown contextualist disposition might prompt a court to use all available evidence to discern the parties' contractual intent.[18]

As evidence of context goes, trade custom – produced by non-parties and discernible through expert testimony and other reasonably objective means – appears more reliable than most. It has been embraced by a broad spectrum of scholars, including some not particularly associated with legal realism or social norms.[19] Custom also plays a prominent role in critiques of textualist description, which point to the fact that trade custom may be embedded in merchant consciousness and behaviour. When merchants claim to be reading the plain text, they are in fact reading through the lens of customary context.[20] Even so, it can be hard to tell what counts as custom, and where to find custom relevant to a given dispute.[21] It can be local, national and global; formal and informal – as in standard contracts and written industry codes, and unwritten norms of behaviour that are more or less widely held, but go without saying. The UCC recognises that custom may be a dynamic mix of fact and law: usage to be discerned by the jury, and rules to be applied by the judge.[22]

Trade groups are the natural and usual guardians of custom in all its forms. Research on trade groups and contracts echoes some of the preceding arguments on interpretation, but adds a distinct set of concerns. First, it takes on the descriptive task of cataloguing associations and their role in the contracting process.[23] Second, it seeks to identify the distinct contribution of trade groups to contracts. Such contributions may be presumptively positive – solving collective action problems among members, reducing transaction costs, collecting and interpreting infor-

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[18] A classic example is Justice Traynor's opinion in *Pacific Gas & Elec. Co.* v. *G.W. Thomas Drayage & Rigging Co.*, 442 P. 2d 641 (Cal. 1968).

[19] See e.g., R. Epstein, 'Confusion About Custom: Disentangling Informal Customs from Standard Contractual Provisions', 66 *University of Chicago Law Review* (1999) p. 821; R. Barnett, 'The Sound of Silence: Default Rules and Contractual Consent', 78 *Virginia Law Review* (1992) p. 821, at p. 862.

[20] D.V. Snyder, 'Language and Formalities in Commercial Contracts: A Defense of Custom and Conduct', 54 *Southern Methodist University Law Review* (2001) p. 617.

[21] R. Craswell, 'Do Trade Customs Exist?', in J.S. Kraus and S.D. Walt, eds., *The Jurisprudential Foundations of Corporate and Commercial Law* (Cambridge, Cambridge University Press 2007) p. 118.

[22] Uniform Commercial Code, Art. 1-303(c): 'The existence and scope of such a usage must be proved as facts. If it is established that such a usage is embodied in a trade code or similar record, the interpretation of the record is a question of law.'

[23] R.C. Ellickson, 'A Review of Legal Scholarship on Informal Order, with a Focus on the Roles of Private Associations', Working Paper (1 October 2011) (on file with authors).

mation, and producing reliable, efficient standard contract terms[24] – or less so, including rent-seeking, anti-competitive and oppressive behaviour.[25]

The question of whether courts should defer to trade groups is related to but ultimately distinct from the question of interpretation strategy. To a narrow textualist, trade groups might well be irrelevant except to the extent they produce contract texts and need incentives to produce ones that are efficient. To others, the question of deference depends on factors ranging from trade groups' legitimacy (as some combination of representativeness and efficacy) to their superior capacity to identify the relevant trade custom and advance the interests of their members.

Law scholars tend to regard trade groups as sources of practical wisdom for public courts and legislatures, as a means of boosting efficiency and lightening judicial workloads, and occasionally, as competitors to the public institutions. By definition, trade groups must have a deep understanding of the ways and preferences of their members. Having codified custom in contract and having tackled many similar disputes, such groups should be able to discern the intentions of the contracting parties and calculate the impact of their decisions on the parties and the industry better than any public court could ever hope to do. Capacity to sanction non-compliance through shunning, expulsion and other non-state means, bolsters trade groups' law-making potential. They can provide significant economies in terms of both dispute resolution and enforcement over the public alternatives.[26] From this vantage point, the continued existence of contract drafting and adjudicating trade groups is evidence of their legitimacy and efficacy.

Not everyone accepts the foregoing description; if it were accurate, trade group-led contracting would be much more pervasive.[27] Nevertheless, the dominant view in legal scholarship is one of optimism about the ability of trade groups to bring expert contextual analysis to the table, and to secure the right outcome at minimal cost. ISDA's role in the Greek crisis presents an opportunity to think about this

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24 K.E. Davis, 'The Role of Nonprofits in the Production of Boilerplate', 104 *Michigan Law Review* (2006) p. 1075; S.J. Choi and G.M. Gulati, 'Contract as Statute', 104 *Michigan Law Review* (2006) p. 1129; R. Scott, 'The Case for Formalism in Relational Contract', 94 *Northwestern University Law Review* (2000) p. 847; R. Scott and C. Goetz, 'The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms', 73 *California Law Review* (1985) p. 261 (Scott and Goetz note that sometimes industry groups can operate at cross-purposes, which detracts from their utility in developing standard terms).

25 D. Charny, 'The New Formalism in Contract', 66 *University of Chicago Law Review* (1999) p. 842; D.V. Snyder, 'Contract Regulation, With and Without the State: Ruminations on Rules and Their Sources. A Comment on Jurgen Basedow', 56 *American Journal of Comparative Law* (2008) p. 723.

26 B. Richman, 'Norms and Law, Putting the Horse before the Cart', *Duke Law Journal* (forthcoming 2012) (suggesting that the literature has significantly underestimated the enforcement value of these groups and overestimated their abilities on the interpretive front).

27 Ibid.; Charny, *supra* n. 25; Snyder, *supra* n. 25.

view in a new setting. After describing ISDA, its contracts and adjudication institutions, we consider a series of contract interpretations by ISDA Determinations Committees. Unlike the prior literature, we end up asking not only what the trade group does for contracts or adjudication, but also what contracts and adjudication might do for the trade group and the broader institutional setting in which it operates.

3. ISDA'S REALM

3.1 **Contract mission**

ISDA emerged in the mid-1980s to standardise a vocabulary for the most basic of derivatives contracts (interest rate and currency swaps), and has risen in prominence along with the market it oversees. The ubiquity of derivatives in all aspects of finance gives ISDA a credible claim to universality within the financial industry, compared to groups responsible for smaller market segments.[28] Yet ISDA's mandate is also limited by its contract mission. Even though just about every institutional participant in the global financial markets uses ISDA's contracts, ISDA does not claim to represent the financial industry in general, or a particular subset of firms, on all manner of contract and policy concerns but only insofar as such firms use its contracts.[29] ISDA is also distinct for its emphatically transnational character. At the start, its mission was to make its contracts work in both New York and London; it has since expanded to the far corners of the globe. Other associations that draft standard-form contracts for multi-trillion dollar markets are rooted in particular national jurisdictions.[30] Still others have a transnational membership and may draft contracts or codes of conduct on occasion, but are not organised around documenting a category of financial instruments and creating a global infrastructure to trade them.[31] ISDA's membership may overlap with those of the other trade groups, but its job and its methods are distinct.

It is hard to conceive of a stronger[32] and more successful trade group in charge of more important contracts than ISDA, if success is to be measured by share of the

[28] ISDA membership lists are available at: <http://www.isda.org/membership/isdamemberslist.pdf>; for a comparison, see, e.g., EMTA, *About EMTA*, available at: <http://www.emta.org>, and *Member Institutions*, available at: <http://www.emta.org/template.aspx?id=65>.

[29] See, e.g., Securities Industry and Financial Markets Association, *About SIFMA*, available at: <http://www.sifma.org/about>.

[30] See, e.g., British Bankers Association, *About Us*, available at: <http://www.bba.org.uk/about-us>.

[31] See, e.g., Institute of International Finance, *About IIF*, available at: <http://www.iif.com/about>.

[32] Ellickson, *supra* n. 12.

contract market and importance by dollar volume or impact on the global economy. To the extent it is feasible, applying the work to trade groups in commercial contract drafting and interpretation could have a tremendous payoff here. Studying ISDA could yield insights for the commercial contracting literature, or illuminate contracts and contracting practices it does not explain.

ISDA shares similarities with the groups described in this literature; we noted some of these at the start of the article. ISDA's markets are insular and informal, dominated by repeat players. Its early task was to standardise the industry lexicon;[33] it has adapted its governance strategies in response to growth and globalisation.[34] But several differences are striking. First, the economic significance of the derivatives market and the ever-present spectre of financial regulation make governments a permanent factor in ISDA's life: unlike diamond and cotton merchants, who can 'opt out' of public institutions by creating parallel private ones, derivatives market participants are in constant battle against government intervention. Second, because derivatives contracts involve so many diverse economic actors and forms of economic activity, they require more reliance on public enforcement. For example, the operation of collateral provisions in ISDA contracts and these contracts' treatment in bankruptcy implicate third parties who might have no other connection to, and have no reputational stake in, the derivatives markets. Perhaps as a result, ISDA's work seems to be as much about interfacing with the outside world as about keeping order among members. Dispute resolution is at best tangential to its mission. In contrast, the rulemaking and contract-drafting of the more familiar merchant associations respond to their dispute resolution needs. As we elaborate later in this section, ISDA's adjudication responded to a distinct set of contract, market infrastructure and regulatory imperatives.

ISDA's contracts are unusual. They are centrally produced under the auspices of a membership committee, coordinated by ISDA staff, with the help of outside counsel. They take a modular form (Figure 1) and are highly standardised, though adapted on the margins by market participants to fit their needs.[35] ISDA takes copyright in the standard forms.

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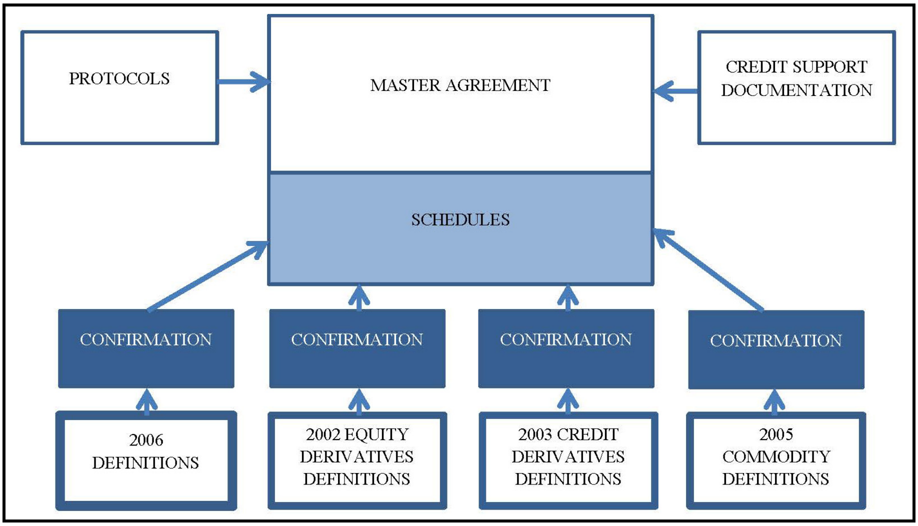
33 Compare mid-20th century textile industry initiatives in Bernstein, 'Questionable Empirical Basis', *supra* n. 6, at p. 733.

34 A.C. Gooch and L.B. Klein, *Documentation for Derivatives*, 4th edn. (Euromoney 2002), at pp. 18-19 (describing ISDA's founding); A. Riles, *Collateral Knowledge: Legal Reasoning in the Global Financial Markets* (University Of Chicago Press 2011) (describing ISDA's work in Japan); compare the diamond industry's adaptation from community to information-based governance in Bernstein, 'Opting Out', *supra* n. 14.

35 See G. Charles, 'The ISDA Master Agreement – Part I: Architecture, Risks and Compliance', *Practical Compliance & Risk Management for the Securities Industry* (January-February 2012); see G. Charles, 'The ISDA Master Agreement – Part I: Negotiated Provisions', *Practical Compliance & Risk Management for the Securities Industry* (May-June 2012); Allen and Overy, 'An Introduction to the Documentation of OTC Derivatives: Ten Themes' (May 2002), available at: <http://www.isda.org/educat/pdf/ten-themes.pdf>.

Figure 1: ISDA Contract Framework
(Shaded portions reflect party or transaction-specific modules; the rest apply market-wide.)



The Master Agreement is at the centre of the ISDA framework. First adopted in 1992, with a new version issued in 2002, the Master operates bilaterally between the parties that adopt it; however, in some respects it resembles an industry-wide constitution. This is because the core terms (representations, covenants, events of default, early termination procedures) apply across the derivatives industry and across all product categories. Parties vary the terms through negotiated Schedules to the Master. The Master also establishes the relationship among the different parts of the contract suite. Protocols effect industry-wide changes to the Master; market participants that accede to a protocol are bound by its terms vis-à-vis others that do the same. Credit Support documentation is another relationship-specific module of the contract. It establishes the terms on which the contracting parties may obtain collateral from each other to mitigate counterparty credit risk. Standard-form Credit Support documents vary by jurisdiction (for example, ISDA offers New York, English and Japanese law annexes). As with the Master, parties adopt the ISDA annexes and use the Schedules to tailor the annex terms to their relationship. Product-specific Definitions are incorporated by reference in individual transactions. Like the Master, these apply market-wide; unlike the Master, they are limited to particular derivatives products, such as equity, credit, or commodities swaps, and over a dozen others. The last piece of the puzzle is the Confirmation, the only transaction-specific document in the suite, which sets out the economic terms of a trade and incorporates the relevant Definitions.

All but the short-form Confirmation are either centrally produced or negotiated in advance between the counterparties. Thus the Master, Protocols and Definitions might be produced by ISDA at different times with the help of one or more big law firms; the Schedules and collateral arrangements are negotiated bilaterally between counterparties, each represented by in-house or outside counsel, and the Confirmations are filled in by traders after they consummate the trade over the telephone.[36] Even the party- and transaction-specific modules start with ISDA standard forms. The entire suite is meant to work across different jurisdictions.[37]

This structure makes it possible for market participants to transact across the globe in a matter of seconds, reflecting the cost savings goal of standardisation. The network effects of having everyone in the market use essentially the same documentation boost liquidity.[38] Buyers and sellers need not draft or analyse new contracts for each new trade, new counterparty, or even new jurisdiction – they know ISDA contracts work and are interoperable; as a result, more stand ready to trade. Standardisation and continued adaptation of derivatives contracts under ISDA's auspices since the late 1980s get credit for the astronomical growth of the derivatives market to over $440 trillion in outstanding notional amounts in late 2011.[39] Over $362 trillion of the total is interest rate contracts. Credit derivatives represent about $26 trillion, of which under $3 trillion is contracts on sovereign debt. CDS have grown quickly, multiplying fifteen-fold since 1982 (interest rate contracts grew fivefold).[40]

ISDA has succeeded at insulating this vast market from intrusive regulation of the sort that defined the rest of the financial industry: ISDA contracts are exempt from securities and commodities regulations[41] and from key bankruptcy law

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36 Delays in confirming transactions drew the attention of regulators in the mid-2000s and led to reforms of industry practice. See BIS Committee on Payment and Settlement Systems, 'New Developments in Clearing and Settlement Arrangements for OTC Derivatives' (March 2007), available at: <http://www.bis.org/publ/cpss77.pdf>.

37 Some modules – notably collateral arrangements – use different governing law; in addition, ISDA secures legal opinions from dozens of jurisdictions assuring its members that its Master and Credit Support agreements would be enforced as written. ISDA, Opinions, available at: <http://www2.isda.org/functional-areas/legal-and-documentation/opinions>.

38 M. Kahan and M. Klausner, 'Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")', 83 *Virginia Law Review* (1997) p. 713.

39 ISDA, 'OTC Derivatives Market Analysis Year-end 2011' (June 2012), available at: <http://isda.derivativiews.org/2012/06/07/342>. Notional amounts do not normally reflect the counterparties' actual exposure, but rather the value of the reference asset on which the transaction is based. For example, if the contract is to swap interest streams on a principal amount of $1 million, the notional amount of the contract is $1 million. ISDA figures are adjusted to exclude foreign exchange derivatives and double-counting in cleared transactions.

40 Ibid.; DTCC Deriv/SERV Trade Information Warehouse Data Section I, Tables 2 and 3, available at: <http://www.dtcc.com/products/derivserv/data_table_i.php?tbid=2>.

41 See, e.g., Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended in scattered sections of 7 U.S.C.); F. Partnoy, 'ISDA, NASD, CFMA,

provisions around the world.[42] To secure and maintain the exemptions, ISDA has interfaced with legislatures, regulators and the courts to position its contracts as both essential and exceptional: essential because they support all manner of financial activity and are indispensable to the functioning of finance, exceptional because they are structured to manage risk among sophisticated parties. In this view, misguided regulation could be socially costly, while its benefits are small and uncertain. But precisely because derivatives are so important, demonstrating sophistication is not enough to keep regulation at bay. Even if the market participants do not need government protection, the potential spillover effects of mishaps in this multi-trillion dollar market call for intervention, unless the industry can show that it can be trusted to keep its own house in order.

In response, ISDA has increasingly assumed a role far beyond traditional lobbying, taking responsibility for market infrastructure and ultimately adjudication. For example, faced with criticism for lack of transparency and long lags in trade documentation,[43] ISDA worked to clean up back-office practices across the industry and centralise trade reporting. It introduced an auction settlement mechanism in the CDS market to counter price distortions, then followed up with an adjudication mechanism to support auction settlement. And when courts in New York interpreted its contracts in ways that ISDA deemed problematic for the market, it responded nimbly, in one case changing the boilerplate, in another filing an amicus brief.[44]

The regulatory truce lasted until 2008 with relatively few disruptions.[45] Then ISDA and the derivatives industry entered a fight for their lives. CDS contracts

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and SDNY: The Four Horsemen of Derivatives Regulation?', *Brookings-Wharton Papers on Financial Services* (R.E. Litan and R. Herring, eds., 2002) p. 213.

42 D. Duffie and D.A. Skeel, 'A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements', University of Pennsylvania, Institute for Law and Economics Research Paper No. 12-02 (1 March 2012), Rock Center for Corporate Governance at Stanford University Working Paper No. 108, Stanford University Working Paper No. 108, available at: <http://ssrn.com/abstract=1982095>; S.J. Lubben, 'Credit Derivatives and the Future of Chapter 11', 81 *American Bankruptcy Law Journal* (2007) p. 405; A. Riles, 'The Transnational Appeal of Formalism: The Case of Japan's Netting Law', Stanford/Yale Junior Faculty Forum Research Paper No. 00-03, 2000, available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=162588>.

43 Committee on Payment and Settlement Systems, *supra* n. 36.

44 Choi and Gulati, *supra* n. 24; *Eternity Global Master Fund Ltd.* v. *Morgan Guaranty Trust Co. of N.Y. & J.P. Morgan Chase Bank*, 375 F.3d 168 (Jul. 9, 2004); Brief of *Amicus Curiae* in Support of the Brief of Defendant-Appellant, *AON Financial Products* v. *Société Générale*, No. 06-1090-CV, at 4-5 (2d Cir. May 8, 2006).

45 The collapse of the Long-Term Capital Management hedge fund in 1998 was a notable disruption, reviving the call for both hedge fund and derivatives regulation. President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (1999), available at: <http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf>.

were at the heart of the fight because of their capacity to create and reduce synthetic exposure to credit risk on a potentially unlimited scale. Labelled 'financial weapons of mass destruction' by Warren Buffett and tools of 'destructive speculation' by European officials, CDS were widely blamed for exacerbating the financial crisis on both sides of the Atlantic.[46] Regulation became a near-certainty at the height of the US mortgage crisis;[47] by the time the focus had shifted to European sovereign debt problems in 2010, outright prohibition was gaining ground.[48]

3.2 CDS, defined

Our case study concerns the interpretation of ISDA Credit Derivatives Definitions in the Greek crisis of 2010-12, when the continued existence of the market was a matter of urgent public debate. The Definitions embody the basic workings of the CDS instrument: a promise by the 'protection seller' to compensate the 'protection buyer' for the loss in value of the underlying 'reference obligation' should a 'credit event' occur with respect to it during the term of the CDS contract. In exchange for this promise of contingent compensation, the protection buyer pays a periodic premium to the seller. The CDS price varies inversely with the price of the underlying debt: for example, if the debtor runs into trouble, its debt prices will fall, it will have to pay higher interest rates, and the price of CDS on its debt should go up. Although the basic structure of the contract resembles bond insurance, unlike insurance, the protection buyer need not hold the bond to buy a CDS on it. Also unlike insurance, CDS contracts are actively traded. Some are more liquid than the underlying bonds.

Market participants' motives for buying and selling CDS vary. Protection buyers may choose CDS to insure against default, or as a way to bet against the

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46 R. Pickel, Testimony Before the Committee on Agriculture, US House of Representatives (8 December 2008), available at: <http://agriculture.house.gov/testimony/110/h81208/Pickel.pdf>; R.M. Stulz, 'Credit Default Swaps and the Credit Crisis', 24 *Journal of Economic Perspectives* (Winter 2010) p. 73.

47 See, e.g., Group of Twenty, Leaders' Declaration of the Summit on Financial Markets and the World Economy, Washington, D.C., 15 November 2008, available at: <http://www.g20.utoronto.ca/2008/2008declaration1115.html>; Testimony of Superintendent Eric Dinallo, New York State Insurance Department, to the United States House of Representatives Committee on Agriculture Hearing to Review the Role of Credit Derivatives in the U.S. Economy (20 November 2008), available at: <http://www.dfs.ny.gov/about/speeches_ins/sp0811201.pdf>; Group of 30, *Financial Reform: A Framework for Stability* (2009), at p. 52, available at: <http://www.group30.org/images/PDF/Financial_Reform-A_Framework_for_Financial_Stability.pdf>.

48 See, e.g., Federal Financial Supervisory Authority (BaFin), Press Release, 'BaFin Prohibits Naked Short-Selling Transactions and Naked CDS in Government Bonds of Euro Zone' (18 May 2010), available at: <http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2010/pm_100518_cds_leerverkauf_allgemeinverfuegungen_en.html>. On the law and economics of short selling, see J. Payne, 'The Regulation of Short Selling and Its Reform in Europe', 13 *European Business Organization Law Review* (2012) p. 413.

underlying credit (or one that is closely correlated).[49] Protection sellers may be expressing optimism about the credit, or their own capacity to manage the risk. If the buyer is a regulated institution, holding CDS can bring regulatory capital relief.

Especially where the CDS contract references a creditworthy debtor (for example, Exxon or Germany), neither the buyer nor the seller of protection might be expecting default. Here, CDS is less like insurance against non-payment and more like an alternative way of betting on relative price movements – a stand-in for the bond itself.[50] CDS are designed to isolate underlying credit risk while stripping out interest rate and currency risks and most transactional contingencies. For example, they would not trigger when an ancillary covenant is breached, when the reference obligation turns out to be unenforceable, or when the currency in which it is expressed loses value. They would trigger when the debtor misses a payment. For this reason, CDS prices are sometimes said to convey better, less noisy information about the underlying credit than the reference obligation itself.[51] CDS can also be cost-effective: selling protection generally does not require up-front funding, but provides the economic equivalent of buying the underlying bond.

The job of ISDA contracts in the CDS market is, among other things, to identify 'credit-related occurrences'[52] that should trigger payouts in a way that supports the inverse relationship between bond and CDS prices. Credit Derivatives Definitions have an important place in the contract architecture because they describe the credit events that apply market-wide. Credit event definitions are default terms that may be varied by the parties; in practice, few market participants diverge from the ISDA standard, because doing so would make their contracts less liquid.

The Definitions booklets cover the universe of credit derivatives, including CDS on corporate, sovereign and municipal obligations in different parts of the world. Individual CDS contracts generally do not include each credit event in the booklet, but follow a menu approach dictated by industry custom. There is robust custom with respect to the terms normally included in each product subcategory; it is expressed in so-called settlement matrices. A settlement matrix lists, among other things, the credit events normally used in Western European Sovereign, Japanese

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49 For example, a bank might not be in a position to cut lending to a client with which it has a valuable relationship, but it can reduce its effective exposure to the credit risk by buying a CDS. For an example of managing apparently correlated risks, see, e.g., *AON Financial Products* v. *Société Générale*, 2007 U.S. App. Lexis 2488 (CDS on the Philippine sovereign bought to hedge against the risk of default by a parastatal).

50 See, e.g., A. Fontana and M. Scheicher, 'An Analysis of Euro Area Sovereign CDS and Their Relation with Government Bonds', ECB Working Paper No. 1271 (December 2010), available at: <http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1271.pdf.>.

51 See, e.g., Stulz, *supra* n. 46; J. Ericsson, K. Jacobs and R. Oviedo, 'The Determinants of Credit Default Swap Premia', 44 *Journal of Financial and Quantitative Analysis* (February 2009) p. 109.

52 See, e.g., D. Duffie, 'Credit Swap Valuation', *Financial Analysts Journal* (January/February 1999) p. 73.

Corporate or US Municipal CDS markets. For example, most corporate CDS include Bankruptcy, Failure to Pay and versions of Restructuring as credit events; for sovereign CDS, the credit events are Failure to Pay, Repudiation/Moratorium, and Restructuring. We discuss these in more detail as they come up in our case study.

Whether particular events trigger payout under ISDA documentation is a question of interpretation. The task of interpretation involves establishing whether the language in the Definitions fits with available information about a credit event (for example, a missed payment). For a tradable instrument, such information should be readily verifiable by third parties: it would be hard to market a contract whose payout relied on private knowledge. It follows that even if an authoritative interpretation of a CDS credit event came out of a bilateral dispute, it would presumptively bind the market as a whole, because it concerns the application of highly uniform contract terms to publicly available facts.

3.3 Big Bang

The derivatives market survived the US government takeover of Fannie Mae and Freddie Mac and the failures of large financial institutions on both sides of the Atlantic without major disruptions. Nevertheless, it quickly became clear that financial reforms the world over would bring about more regulation of derivatives, most likely in the form of mandatory central clearing.[53] In turn, the onset of central clearing required a quick response to some known shortcomings with CDS settlement and interpretation. The result was more standardisation and formalisation – and tighter coordination with government regulators. In response to prompting from the US President's Working Group on derivatives, ISDA's 'Big Bang Protocol' made auctions for CDS credit events the default settlement method beginning in March 2009. Where in the past, parties might have scrambled to find defaulted securities to deliver in exchange for their CDS payout, auctions would facilitate cash settlement by establishing market prices for deliverable obligations and the net payments due. The new settlement process would also ensure that dealers and central counterparties who bought and sold protection at the same time faced symmetrical risks. These market participants entered into multiple contracts designed to cancel out one another's risk; but their role depended on consistent interpretation of the contracts. If this could not be assured, the dealer or clearing house faced legal 'basis risk': it might find itself paying out on some CDS but unable to collect on the offsetting ones.

Expanding the auction mechanism thus raised the problem of contract interpretation anew. Before the Big Bang, if contract counterparties disagreed whether a 'credit event' had occurred and a CDS payout obligation had been

[53] Group of 20, s*upra* n. 47.

triggered, they could try to settle the question informally, or go to court – and some did.[54] Individual market participants could also opt in or out of auctions after the credit event had occurred. Interpretive questions were decided *ad hoc*, usually after the adverse event but before the auction; market participants could then decide whether to opt into the auction or go their bilateral ways. Now that most would go to auction, ISDA needed ‘a formal, objective process for resolving auction-related determinations’.[55]

Thus emerged five Credit Derivatives Determinations Committees, each assigned a geographic region. Unlike traditional adjudicative bodies, the DCs do not resolve party disputes based on adversarial submissions. Instead, they answer standard-form questions posed by market participants, who choose the questions from a limited menu. Common questions include whether a credit event has occurred within the meaning of Credit Derivatives Definitions, whether an auction should be held, and what obligations may be delivered into such an auction. DC membership includes ten CDS dealers (firms that stand ready to buy and sell the contracts) and five non-dealers. Dealers must meet aggregate trade volume criteria, which are described as proxy for market expertise; non-dealers are subject to minimum size requirements. ISDA serves as DC secretariat. The DCs are also advised by a law firm working with ISDA, but not on behalf of a particular party. DC decisions require an 80% supermajority vote of the 15-member committee. The threshold is designed to signal consensus and non-dealer inclusion. If no supermajority is reached, the question is referred to External Review, which is more like traditional arbitration, including trained lawyers as adjudicators, adversarial submissions and arguments by law firms on behalf of ISDA members.[56] In May 2012, ISDA reported that unanimous decisions were reached for 96% of the 900 questions referred to its DCs; only one case was referred to External Review. DC decisions, including member votes, but not panel reasoning, are published on the ISDA website.

Although they are routinely conflated, the DCs are distinct from ISDA itself. DC members serve on behalf of their firms and may be motivated by these firms’ respective private agendas. However, assuming the process works as advertised, DC decisions over time should track ISDA preferences. If DC members have limited opportunity to cherry-pick cases or ‘vote their book’, they have few incentives to invest in individual disputes: they make money from trading derivatives, not judging cases. While DC members rotate, ISDA serves as secretariat in each case; moreover, each case concerns the viability of the contracts and contracting model that are at the heart of its mission. And if market participants

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54 ISDA, The ISDA Credit Derivatives Determinations Committees (May 2012), available at: <http://www2.isda.org/attachment/NDM1NA=/AGM%202012_DC%20anniversary_appendix_043012.pdf>.

55 Ibid.

56 For a description of an External Review proceeding, see, e.g., ‘Derivatives Law Firm of the Year: Allen & Overy’, *Risk Magazine* (January 2012) p. 70.

believe that ISDA and the lawyers it hires are expert and impartial, it makes sense for DC members to defer to ISDA's judgment on the meaning of its standard-form contracts. No other actor has a bigger stake in a consistent stream of robust interpretations. To be sure, if the assumptions of process integrity, trust and impartiality are far off the mark, our analysis must be qualified. For most of this article, we proceed with the assumptions intact; we revisit them in the conclusion.

DC interpretations are binding on the parties to ISDA contracts. A large subset of derivatives market participants, including all major regulated institutions, 'voluntarily expressed their commitment to auction hardwiring in public letters to regulators'.[57] Once the major dealers signed up to the new settlement and interpretation process, opting out became costly for non-dealers even if they themselves were unregulated. Binding force is formally achieved through market participants' contractual commitment in the Big Bang Protocol to settle their CDS through ISDA auctions. As a practical matter, then, market actors refusing to abide by the DC process or rulings may face lawsuits from their contract counterparties, unspecified supervisory response from financial regulators, and a mix of formal and reputational sanctions in the industry, including banishment from future DC deliberations.[58]

ISDA's description of the DCs' interpretive approach comes across, at first blush, as contextualist. DC members, bound by contract to follow DC rules (including elaborate conflict of interest safeguards), are expected to perform their obligations 'in a commercially reasonable manner'. Although 'DC members do not have the discretion to disregard the terms of the contract', they are 'sensitive to the broader context of the CDS market and are able to draw on their experience and expertise to take a more purposive interpretation of the Credit Derivatives Definitions than a court might'.[59]

The contextualist mission itself comes in a broader context. ISDA's early involvement in public CDS litigation was decidedly textualist: faced with a lower court interpreting its contracts as the economic equivalent of insurance, ISDA intervened and secured a strict construction of its text on appeal.[60] On another occasion, which we elaborate later in the article, ISDA effectively admitted that a court had uncovered an ambiguity in its contract, and proceeded to redraft it so it was less susceptible to multiple readings and less prone to contextual inquiry.[61] In

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57 ISDA, *supra* n. 54.

58 Compare Richman, *supra* n. 26.

59 ISDA, *supra* n. 54, at p. 5.

60 Brief of *Amicus Curiae* in Support of the Brief of Defendant-Appellant, *AON Financial Products* v. *Société Générale*, No. 06-1090-CV, at 4-5 (2d Cir. May 8, 2006); *AON Financial Products* v. *Société Générale*, 2007 U.S. App. Lexis 2488.

61 Choi and Gulati, *supra* n. 24; *Eternity Global Master Fund Ltd.* v. *Morgan Guaranty Trust Co. of N.Y. & J.P. Morgan Chase Bank*, *supra* n. 44; A. Gelpern, 'Domestic Bonds, Credit Derivatives, and the Next Transformation of Sovereign Debt', 83 *Chicago-Kent Law Review* (2008) p. 147.

both cases, contract standardisation gave the court rulings significance far beyond the disputes at hand.

Against this background (and quite apart from the needs of the auction mechanism), taking adjudication private could be viewed as a way of pre-empting uninformed contextualism on the part of the lay judiciary, in the name of the broader CDS market. It also dispensed with the problem of siding with one member against another in public contract disputes. Early on, ISDA would not intervene in disputes between members; this position was becoming harder to maintain as it sought to grow and diversify its membership beyond the dealer core, as courts looked likely to rule on more issues of market-wide significance, and with the looming prospect of regulation.

Nevertheless, once adjudication migrated out of the judiciary, there was no reason to doubt the DCs' contextualist promise. By taking over credit event determinations in a process with reasonably credible safeguards against systematic dealer bias,[62] ISDA dispensed with some of the more important arguments for textualism. Investors could now invest in the knowledge that their counterparties had no scope for manipulating trigger and payout decisions, misrepresenting their true intent, or the contracting circumstances.[63] The DCs were free to issue contextualist rulings reflecting market expectations and the economics of credit risk transfer.

Such contextualism could, in turn, help guard against the risk of manipulation that resided outside the derivatives contract. If payout determinations were made on the basis of contract text alone, a debtor referenced in a CDS contract but not party to it could try to default and restructure in substance, but not in form, so as not to trigger the bets on its default and restructuring. If the debtor succeeded, it would make fools of the gamblers' contracts as they stood by, helpless to affect the outcome. But why would any debtor do it? And would ISDA DCs, with their market expertise and discretion to call it like it is, guard against such debtor opportunism?

4. Sovereign Chickens Come Home to Roost

4.1 Bright lines in grey zones

From the start, sovereign CDS presented tricky drafting and interpretation problems. Although they have always been a small part of the CDS market, and although lawsuits over CDS contract interpretation were rare even before ISDA

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62 R.E. Scott and G.G. Triantis, 'Incomplete Contracts and the Theory of Contract Design', 56 *Case Western Law Review* (2005) p. 187 (on designing contracts with an eye to dispute resolution); ISDA, *supra* n. 54 (on DC composition and voting rules).

63 Schwartz and Scott, *supra* note 5; Schwartz and Scott, *supra* n. 11.

DCs, sovereign CDS figured prominently in the early disputes. This puzzle may be due to the fact that CDS, like bond insurance, is a bright-line instrument – whereas sovereign debt distress is an unusually grey zone.

When corporate debtors run into trouble, they might stop paying their debts, file for bankruptcy, or restructure their debts in bankruptcy's shadow. In any case, they stand a real chance of ending up in court, which can make them pay. A sovereign debtor cannot file for bankruptcy protection – nor can it be compelled to pay, or turn over its property to creditors. This is because in most cases, sovereign property outside its borders is immune; property inside the country is effectively unreachable. To be sure, there are many ways in which determined creditors can bully weak governments into paying them, but this is a far cry from the relatively straightforward world of commercial debt enforcement.[64] If a sovereign is able to borrow from its own citizens or under its own laws, its repertoire of debt management options expands in proportion to the power it wields at home. On the other hand, debt moratoria and outright government defaults tend to bankrupt domestic banking systems and cause extreme disruptions in the financial markets. As a result, formal moratoria and defaults have become rare. Government debt troubles end in restructuring operations usually described by oxymoronic euphemisms like 'quasi-voluntary', 'moral suasion', and 'Private Sector Involvement' (or PSI).[65]

A binary mechanism of the sort embedded in a CDS instrument is not good at handling oxymorons and euphemisms. For example, consider how one might draft a payout trigger to distinguish between the following scenarios:

– A government comes to its creditors, hat in hand, and says: 'I had a bad hurricane season, and have no money to pay you. Would you stretch out the maturities on my bonds by a couple of years?' The creditors might say no, and face the prospect of default and chasing the government's assets around the globe for a decade[66] – or they might say yes, and extend the maturities, hoping for the best.

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64 See, e.g., T. Laryea, 'Donegal v. Zambia and the Persistent Debt Problems of Low Income Countries', 73 *Law and Contemporary Problems* (2010) p. 193. Contrast Zambia's plight with Argentina's ability to keep holdout creditors at bay for over a decade. Even after winning significant victories in New York and London holdouts have struggled to collect for lack of available assets. See, e.g., *NML Capital Limited* v. *Republic of Argentina*, [2011] UKSC 31; B. Van Voris and D. Benson, 'Argentina Seeks to Reverse US Court on Defaulted Bonds,' Bloomberg, 23 July 2012, available at: <http://www.businessweek.com/news/2012-07-23/argentina-seeks-to-reverse-u-dot-s-dot-rulings-on-defaulted-bond-debt>.

65 See, e.g., N. Roubini and B. Setser, *Bailouts or Bail-Ins: Responding to Financial Crises in Emerging Economies* (Council on Foreign Relations, Washington DC 2004).

66 See, e.g., *EM, Ltd.* v. *Republic of Argentina*, *NML Ltd.* v. *Republic of Argentina*, 2009 WL 2568433 (18 August 2009), *EM, Ltd.* v. *Republic of Argentina*, 389 Fed. Appx. 38 (2d Cir., 3 August 2010), cert. denied 131 S.Ct. 1474 (22 February 2011). See also A. Frankel, 'U.S. Walks

– A different government approaches another set of creditors, and says: 'We all know that I am much better off now than I was when you first lent me the money. I could of course refinance this debt cheaply in the markets, but we might both benefit by extending the maturities a bit.' The creditors agree.

In both cases, the government has restructured its debt on terms more favourable than before. In both cases, creditors have consented to amending the obligations they hold because that was the best choice for them under the circumstances; they are free at all times to reject the government's terms. A variant on the two scenarios might involve the sovereign going into the market and exchanging old debt for new debt with more favourable terms. In the hurricane hypothetical, the government expressly or implicitly threatens default, but does not actually default. Did either set of creditors suffer a 'Restructuring Credit Event' under a CDS contract?

Common sense would suggest that where the sovereign wants to reprofile its debt because its financial condition has improved, there should be no credit event – otherwise the CDS instrument would turn into insurance against good states of the world. If CDS prices are to convey information about the underlying credit quality, the CDS contract must be written to trigger only when the amendment, or the debt exchange, comes about because the debtor's condition has worsened. An early version of sovereign CDS definitions, which expressly contemplated debt exchanges, attempted to solve this problem by reference to the creditors' state of mind: if the exchange were voluntary, there would be no credit event; if it were mandatory, payout would be due.

This formulation created more problems than it solved. 'Mandatory transfer' in ISDA 1999 Credit Derivatives Definitions[67] was not a rule, but a standard, and one that turned out to be notoriously hard to apply. Courts started having trouble administering this standard right away, when Argentina technically secured some creditors' assent to restructuring in late 2001, even as it left them deeply unhappy.[68] The industry responded with bright-line rules in the form of a contract revision, the 2003 ISDA Credit Derivatives Definitions, produced with input from eminent derivatives and sovereign debt lawyers in New York and London.[69]

Dangerous Line to Support Argentina in Bond Cases', *Thompson Reuters* (9 April 2012), available at: <http://newsandinsight.thomsonreuters.com/Legal/News/2012/04_-_April/U_S_walks_dangerous_line_to_support_Argentina_in_bond_cases> (US position in the latest round of creditor lawsuits against Argentina undermines already weak sovereign debt enforcement).

67 ISDA, 1999 ISDA Credit Derivatives Definitions, §§ 4.7(a), 4.9 (1999).

68 *Eternity Global Master Fund Ltd.* v. *Morgan Guaranty Trust Co. of N.Y. & J.P. Morgan Chase Bank, supra* n. 44.

69 ISDA, 2003 ISDA Credit Derivatives Definitions, § 4.7(a) (2003 Definitions), as amended by the May 2003 Supplement to the 2003 ISDA Credit Derivatives Definitions and the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions (14 July 2009).

Under the new regime, a Restructuring Credit Event would be deemed to occur if one of the following three categories of bad things befell the underlying obligations, and did so in a form 'binding on all' holders of such obligations:

– A change in payment terms, defined as a reduction in the rate of interest or amount of principal payable (colloquially known as a 'haircut'); or a deferral of payment of interest or principal;
– A change in ranking that results in subordination; or
– A change in currency: a change in the currency of payment to a currency that is not legal tender in a G7 country or an AAA-rated OECD country.[70]

The crucial shift was from the apparently inadministrable standard ('mandatory') to a bright-line rule ('binding on all'). Lawyers involved in the drafting of the 2003 Definitions report that 'binding on all' was indeed conceived of as a rule, meant to cover two scenarios: first, when a government amends its domestic-law debt by statute or decree, and second, when a supermajority of creditors under the relevant obligation vote to amend it, and by their vote bind the dissenting minority. The revised Definitions track this account. They trigger if the adverse change 'occurs', 'is agreed' between the debtor and 'a sufficient number of holders', or 'is announced (or otherwise decreed)' by the debtor or 'a Governmental Authority', in all cases in a form that binds all creditors. From now on, no court would have to inquire into the creditors' volition. By implication, arm-twisting and threats of default without recourse that did not legally bind all creditors – but brought about the same economic result – did not amount to a credit event.

This new definition of Restructuring was supposed to make sovereign CDS interpretation more predictable and transparent. It also made it narrow and acontextual. Most modern-day sovereign restructurings up to that point had used neither statutory nor contractual amendment to secure debt relief.[71] They relied on a threat of non-payment, made credible by the remaining protections of sovereign immunity.[72] Good sovereign restructuring practice was to make the threat just vague enough not to count as repudiation (an event of default under the debt contracts, as well as a CDS trigger), but few were fooled. Creditors rarely ignored statements such as 'Regrettably, we cannot assure sufficient funds …'. Ironically, because so many heeded the warning, the few remaining holdouts were often paid off quietly after the rest had restructured. Obscure and byzantine, verging on

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70 Ibid.

71 F. Sturzenegger and J. Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises* (Massachusetts, MIT Press 2006); U. Panizza, et al., 'The Economics and Law of Sovereign Debt and Default', 47 *Journal of Economic Literature* (2009) p. 1.

72 M. Gulati and J. Zettelmeyer, 'Making a Voluntary Greek Debt Exchange Work', 7 *Capital Markets Law Journal* (2012) p. 169 (defining a voluntary exchange as one without the customary threat of default).

perverse, the process seemed to work: by 2003, a handful of countries had secured deep debt relief with more than 90% creditor participation.[73] Barring dramatic change in this way of managing sovereign debt distress, the new improved Credit Derivatives Definition would cover a small and uncertain category of events.

In 2003, there was good reason to think that sovereign restructuring practice would indeed change – and the people involved in revising ISDA's CDS definitions were at the forefront of that change.

The sovereign CDS market emerged in the 1990s, just as the large developing economies that were its principal reference entities shifted their international borrowing from loans to tradable bonds. Roughly half of these bonds were issued under New York law and, by market convention, required unanimous consent of the bondholders to amend the terms. In contrast, bonds issued under English law could be amended with a supermajority vote of the creditors, binding the minority. Policy makers in wealthy G-7 countries feared that New York's unanimity requirement would impede sovereign debt restructuring in the next crisis and cause developing countries and their bondholders to demand bailouts from Washington and Brussels. The solution was either statutory sovereign bankruptcy – which did not have enough political support[74] – or a change in market practice favouring supermajority amendment and other provisions to promote bondholder collective action in New York law bonds. The market practice shifted to such 'collective action clauses' (CACs) in 2003, at about the same time as ISDA was amending its Credit Derivatives Definitions.[75] Within a few years, nearly all developing country bonds governed by foreign law permitted creditor supermajorities to bind holdouts in a restructuring.

If the international officials and the leading sovereign restructuring lawyers were right and the inclusion of CACs in sovereign debt contracts would prompt sovereigns and their creditors to use them each time they needed debt relief, then the new improved sovereign CDS contracts would finally track the newly standardised management of sovereign distress. The signs from the developing world were encouraging: before the decade was up, Belize and the Seychelles had restructured their foreign debt stocks using CACs; several bigger countries used the clauses to restructure isolated bond issues.

But like Tolstoy's unhappy families, every sovereign debt crisis unfolds in its own unhappy way.

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[73] Sturzenegger and Zettelmeyer, *supra* n. 71, pp. 91-230.

[74] B. Setser, 'The Political Economy of SDRM', in B. Herman, J.A. Ocampo and S. Spiegel, eds., *Overcoming Developing Country Debt Crises* (Oxford University Press 2010) p. 317.

[75] We describe this market shift and the politics behind it in detail in an earlier article: A. Gelpern and M. Gulati, 'Public Symbol in Private Contract: A Case Study', 84 *Washington University Law Review* (2006) p. 1627.

4.2 Greece

The Greek debt crisis began in late 2009. A newly elected government told the world that its predecessors had cooked the books. Greece's debt and deficit reality was far worse than the figures it had reported to Brussels.[76] Greece was in a deep fiscal crisis and in breach of its EU Treaty commitments. However, Greece was also a wealthy country that used the euro as its currency and issued most of its debt under Greek law. The locus of sovereign restructuring and sovereign CDS shifted from the international debt of developing countries, which accounted for a little over $600 billion, or 1% of all outstanding government securities, to the domestic debt of developed countries, which stood at over $30 trillion, or 84%.[77] The stakes for the rich countries and the global financial system suddenly went up astronomically.

Eurozone government debt had become a 'safe asset' in many parts of the world. It competed with the US dollar in its money-like qualities as a global store of value and medium of exchange. To the policy makers vested in this status of the euro – in Brussels, but especially at the European Central Bank (ECB) in Frankfurt – allowing default on eurozone debt would be akin to debasing money, a first step on the sure road to perdition. A 'credit event' under Greek CDS both symbolised default and threatened a cascade of failures across the European financial system still reeling from the 2007-2008 crisis. Because officials did not know who had bought or sold the CDS contracts, the path of such a cascade was highly uncertain. More subtly, a sharp and visible drop in the status of Greek debt, such as a CDS trigger or a 'Default' credit rating, would force hard decisions about the ECB's own holdings of Greek debt, and its policy of lending against Greek government debt to the Greek banking sector. On the one hand, taking losses on its sovereign debt holdings and lending against demonstrably bad assets would be a blow to the bank's credibility. On the other hand, cutting off Greek banks from the ECB lifeline would be tantamount to pushing them and the Greek economy off the cliff, cancelling any benefit from debt relief.

In short, allowing Greece to restructure its debt along the lines contemplated in the CDS contracts on Greek bonds was unthinkable. The obvious alternative was to give Greece the money to pay. This was equally unthinkable, both because such a transfer appeared to violate EU Treaties and, more importantly, because the public elsewhere in Europe was not prepared to finance Greece and its creditors. These uniquely European imperatives took Greece back to the old grey zone of quasi-voluntary sovereign restructuring and PSI. Greece had to get debt relief, but in a

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[76] See G. Wearden, 'Greek Debt Crisis: Timeline', *The Guardian*, 5 May 2010, available at: <http://www.guardian.co.uk/business/2010/may/05/greece-debt-crisis-timeline>.

[77] Bank for International Settlements, BIS Securities Statistics and Syndicated Loans, Tables 12D and 16A, available at: <http://www.bis.org./statistics/secstats.htm>.

way that did not trigger a CDS credit event or a cascade of credit ratings downgrades.[78] By mid-2011, this meant most likely a formally voluntary debt exchange spurred on by a mix of veiled threats and backdoor regulatory sweeteners for the European banks and insurance companies that comprised the bulk of the creditor base.[79]

4.3 The prospect of a voluntary trim

When European policy makers conceded that some form of PSI was necessary in late 2010, Greece and the EU leaders publicly insisted that any debt relief operation would be voluntary: creditors would not be threatened with default. This put Greece in a more difficult position than its developing country predecessors. The latter had not been burdened with the need to preserve the value of the dollar or the euro they had borrowed; no one would infer trouble for the US dollar from Uruguay's default. As a result, Uruguay could dolefully point to its neighbour Argentina to help its creditors see the light. If Greece pointed to Argentina, it would be accused of imperilling the euro.

Behind the scenes, discussions between Greece's European backers and the Institute of International Finance (IIF), which came to speak for the institutional creditors in the debt talks, apparently produced consensus around a voluntary operation, which would result in a net present value reduction (haircut) of 20% on Greek bonds.[80] The talks culminated in a joint announcement by euro area heads of state, heads of government, and EU institutions, concerning new measures from the official sector and a private sector contribution:

> The financial sector has indicated its willingness to support Greece on a voluntary basis through a menu of options further strengthening overall sustainability. The net contribution of the private sector is estimated at 37 billion euro. … Credit enhancement will be provided to underpin the quality of collateral so as to allow its continued use for access to Eurosystem liquidity operations by Greek banks. We will provide adequate resources to recapitalise Greek banks if needed.[81]

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78 A. Rinke and N. Barkin, 'Europe Eyes Private Sector Role in Greek Debt Deal', Reuters, 8 June 2011, available at: <http://uk.reuters.com/article/2011/06/08/uk-eurozone-idUKTRE7572 0020110608>.

79 Ibid.; J. Ewing, 'Already Holding Junk, Germany Hesitates', *New York Times*, 28 April 2010, available at: <http://www.nytimes.com/2010/04/29/business/global/29banks.html?dbk>.

80 This valuation of the exchange was debatable and vigorously debated; the precise value of the haircut is unimportant for our purposes.

81 Council of the European Union, Statement by the Heads of State or Government of the Euro Area and EU Institutions, Brussels, 21 July 2011, available at: <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf>.

The IIF posted a detailed 'Financing Offer' on its website, including a menu of options and terms for two par and two discount bonds to be offered in exchange for outstanding Greek debt, and a list of over forty institutions 'in support' of the proposal.[82] To be sure, Greece had not accepted the IIF offer, nor had it made a formal offer of its own to the creditors, and no changes had been made to the terms of Greek bonds. But under the circumstances, it appeared that the relevant decision-makers – EU officials and big financial institutions – had come to agreement and were marketing a deal.

The marketing campaign brought up two questions, which turned out to be related. The first was how and why the creditors would voluntarily take less than they were owed in the largest sovereign restructuring to date. The second was whether, if consummated, the restructuring would trigger the CDS contracts. In substance, the 20% haircut would be a substantial realisation of Greek sovereign credit risk, whether it was suffered under protest, accepted with resignation, or granted lovingly in a bout of patriotic fervour. The legal answer could be more complicated: the 2003 Credit Derivatives Definitions said that a Restructuring Credit Event would occur if the underlying debt contracts were amended, and if the amendment were 'binding on all' holders of the relevant bonds. Europe had expressly ruled out the possibility of binding anyone when it promised a voluntary operation in Greece, and openly justified its approach by the need to avoid CDS triggers.

But Greece had other ways of prodding its creditors in the right direction. Unlike the previously restructured developing country bonds and the covenant-laden debt which Greece had issued in the past, over 90% of Greek sovereign bonds outstanding at the onset of the crisis had been issued under Greek law. After Greece joined the eurozone, investors started buying its term-free Greek-law bonds much as they would Germany's term-free German-law bonds. Greece's local law bonds had no CACs, nor did they have clauses barring new secured borrowing, withholding taxes, or any other mischief that could effectively wipe out their value to the creditors. Under an old foreign-law bond, pledging collateral or imposing punitive taxes without compensation would have let the creditors accelerate (demand full repayment). When Greece failed to pay the accelerated amounts, creditors could be left out in the cold – but would collect on their CDS. None of this had to happen to make the voluntary PSI deal work. Greece could make holdout debt worthless without threatening non-payment, triggering an event of default on the bonds or a CDS credit event. The offer of performing debt at 20% off would be attractive by comparison.

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82 Press Release, 'Greek Financing Offer: Statement by IIF Board of Directors', 21 July 21 2011, available at: <http://www.iif.com/press/press+198.php> (including links to the Financing Offer and list of Financial Institutions in Support).

In 2011, Greece and Europe were unwilling to take advantage of this contractual windfall, perhaps because they had other options. At the time PSI was mooted, Greek debt was still held primarily by large regulated financial institutions – banks, insurance companies and pension funds in Greece and elsewhere in Europe.[83] Such institutions are famously susceptible to 'moral suasion', supervisory and accounting incentives.[84] During the Third World Debt Crisis of the 1980s, banks were persuaded to renew loans and ultimately (if belatedly) to grant substantial debt reduction, with no or minimal resort to default or legal compulsion.[85] Similarly, Greece and Europe had extra-contractual ways of extracting debt relief from Greece's creditors, so long as large regulated firms continued to dominate the creditor body. These ways were hardly a state secret: market participants openly discussed regulatory incentives such as favourable collateral treatment for restructured debt, and corresponding penalties for holdouts.[86]

In sum, if Greece and Europe wanted to reduce Greek debt by 20% without formally binding a single creditor or threatening non-payment, they had ample sticks and carrots to do so. All along, officials could claim that the exchange was voluntary, and more to the point, easily avoid triggering CDS – but only if ISDA DCs stuck to the letter of the contract.

The voluntary deal never came to fruition for reasons unrelated to the law. The Greek economy deteriorated so quickly that it made the admittedly optimistic terms look paltry overnight; they were nowhere near enough to put Greece on a sustainable debt path. As a result, we do not know for sure what an ISDA DC would have said had the operation proceeded as planned. However, the episode was significant in two ways. First, it illuminated a credible path to restructuring even within the peculiar parameters dictated by European politics. Second, the avalanche of press speculation about what might happen to the CDS prompted ISDA to offer a preview of its thinking.

Shortly before the terms of the 20% exchange were made public in July 2011, ISDA posted 'Greek Sovereign Debt Q&A', where it sought to describe the DC process and the criteria for a Restructuring Credit Event, including the 'binding on all' element. ISDA updated the Q&A and issued a press release in late October. While noting that it was too early for a DC to rule on an exchange proposal, ISDA went out on a limb to observe: 'Based on what we know it appears from preliminary news reports that the bond restructuring is voluntary and not binding on

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83 *Supra* n. 79.

84 See e.g., *United States* v. *Winstar Corp.*, 518 U.S. 539 (1996).

85 A. Mudge, 'Sovereign Debt Restructure: A Perspective of Counsel to Agent Banks, Bank Advisory Groups and Servicing Banks', 23 *Columbia Journal of Transnational Law* (1984) p. 59; W.R. Cline, *International Debt Reexamined* (Institute for International Economics 1995).

86 Rinke and Barkin, *supra* n. 78.

all bondholders. As such, it does not appear to be likely that the restructuring will trigger payments under existing CDS contracts.'[87]

Although ISDA had issued interpretive releases of this sort in the past,[88] doing so pre-emptively against the background of admittedly high uncertainty, and with such high stakes, seemed extraordinary. The statement could not have been made without consulting with – perhaps even some prodding from – at least some of the membership, European officials, and outside counsel called upon to advise the DCs. The statement was also curious in substance. For example, it illustrated the 'binding on all' criterion with a description of voting under CACs, yet also noted that 'Greece's domestic law debt, which accounts for over 90% of all of its outstanding debt, does not contain CAC clauses' [sic]. Perhaps most importantly, ISDA confirmed that even a distressed debt exchange 'typically would not trigger a Credit Event' because it did not involve amendment of the underlying contract. Recalling our earlier hypothetical, because most sovereign debt restructurings proceed through debt exchanges, and because CDS contracts have no way of distinguishing a distressed exchange from one prompted by an improvement in the debtor's finances, CDS contracts have no 'hook' into the dominant mode of sovereign restructuring.

In sum, in the second half of 2011, ISDA faced the prospect of a debt exchange most likely achievable by making holdout bonds worthless using contract and regulation. This was entirely consistent with the way in which most sovereign debt had been restructured in the recent past.[89] By its own admission, ISDA did not have to rule on the matter until a restructuring actually happened. Instead, it took the opportunity to articulate an emphatically narrow reading of its CDS contracts, which hinged on the words 'binding on all'. Doubling down on the distinction between contract text and economic context, ISDA's Q&A observed: 'Economically they [exchange and amendment] may be the same but legally they are different, which could have very different consequences for CDS.'[90] This was fair enough, but left unanswered a fundamental question: what was the economic function of sovereign CDS, thus framed by ISDA's contracts? This question would come up repeatedly in the ensuing months.

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[87] ISDA, ISDA Statement on CDS Credit Event Process, and ISDA, Greek Sovereign Debt Q&A (Update), available at: <http://www2.isda.org/greek-sovereign-cds>.

[88] For example, in connection with Japan's takeover of a large bank in the middle of a financial crisis. See 'Int'l Swap Traders' Group Satisfied with Japan's Help for LTCB', *Jiji Press Ticker Service*, 22 October 1998.

[89] See R. Bi, M. Chamon and J. Zettelmeyer, 'The Problem that Wasn't: Coordination Failures in Sovereign Debt Restructurings', International Monetary Fund, Working Paper No. 11/265 (2011), available at: <http://www.imf.org/external/pubs/ft/wp/2011/wp11265.pdf> (attributing the relatively smooth progression of sovereign debt restructurings beginning in the late 1990s to techniques such as 'exit consents', which impaired the value of non-participating bonds).

[90] ISDA, *supra* n. 87.

4.4 Collateral murmurs

The 21 July package of measures, including the IIF-led private sector involvement, began unravelling soon after it was announced. The Greek economy continued to decline, along with the government's political capacity to abide by the policy conditions for external official support. But one seemingly minor portion of the package stuck: Finland, representing about 2% of EU official financing for Greece, demanded and later secured collateral for its participation.[91] The demand was partly a function of complex Finnish coalition politics; Europe's acquiescence was likely due to the combination of Finland's financial insignificance and the political importance of projecting European unity. However, once the Finnish deal became public, several other eurozone countries felt compelled to demand collateral for their citizens as well, though none have gone as far as Finland.

By mid-2011, nearly every turn in the Greek saga prompted speculation about CDS triggers and ratings downgrades. The Finnish collateral deal was no exception for a mix of economic, legal and political reasons. Economically, granting one set of creditors collateral effectively reduces the stock of assets from which the rest could get paid. That is why bonds have so-called negative pledge clauses, which typically bar the debtor from pledging collateral for future borrowing unless the bonds are proportionately secured. It seemed quite plausible at the time that someone holding one of the few term-heavy English-law bonds issued by Greece would try to claim that the Finnish deal violated their negative pledge clause.[92] However, CDS contracts would not trigger on negative pledge violations: these would constitute covenant defaults not normally included in credit event definitions, even though the economics of granting collateral to Finland amounted to constructive subordination of Greece's unsecured creditors.

Given ISDA's declared reluctance to trigger credit events based on the economic effect of a debt management operation,[93] it was perhaps no surprise that Finland's move to the head of the creditor line elicited no response from the Determinations Committees. However, one might have expected more of a debate about the degree to which existing CDS credit events reflect economic harms that might befall a bondholder. Bonds, after all, have both negative pledge and ranking covenants. There is no apparent rationale for CDS to have subordination, but not negative pledge triggers, especially since the two serve parallel economic functions.

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[91] See, e.g., 'Resentment in the North: Rich EU Members Lose Patience with the "Olive Zone"', *Der Spiegel International Online*, 23 August 2011, available at: <http://www.spiegel.de/international/europe/resentment-in-the-north-rich-eu-members-lose-patience-with-the-olive-zone-a-781710.html>.

[92] J. Cotterill, 'The Greek Collateral Grab: A Credit Event After All?', *FTAlphaville Blog*, 23 August 2011, available at: <http://ftalphaville.ft.com/blog/2011/08/23/660046/the-greek-collateral-grab-a-credit-event-after-all>.

[93] *Supra* n. 90 and accompanying text.

Incidentally, credit rating agencies did not feel ISDA's constraints. Moody's warned that the Finnish collateral arrangement exacerbated political obstacles to EU financing for Greece and threatened the viability of the rescue package, further weakening the outlook for Greece.[94]

4.5 Retro-CACs

By early 2012, everyone had long given up on the voluntary 20% debt relief operation; the new consensus came closer to 70% debt relief, and the subject of coercion resurfaced. Still, Europe was unwilling to countenance default. However, compared to the threat of outright default or unilateral amendment, CACs – the contract clauses that allowed supermajority amendment – began to look attractive. There was a collaborative feel to this contractual mechanism, which also benefited from a long and close association with official sector policies promoting 'orderly sovereign restructurings'. But the bulk of Greek debt, term-free and governed by Greek law, had no CACs.

Greece's lawyers had an ingenious solution: the government would enact a statute retroactively 'inserting' CACs in its domestic-law debt. Once it had done so, it could try to secure the consent of a bondholder majority to its preferred restructuring terms, and bind any holdouts. In February 2012, the Greek Bondholder Act cleared the parliament. Under its terms, creditors holding half of roughly €180 billion of Greece's local-law debt by face value constituted a quorum, and two thirds of the quorum could vote to amend the entire stock of this debt binding the rest.[95]

While ingenious, this statutory solution had little in common with its contractual namesake. The original CACs were, by definition, consensual – agreed by the creditors ex ante either when the bond was issued or when they bought the bond. This consensual nature of CACs was such a powerful part of their image that some leading observers, including drafters of a European Commission report in December 2010, had mistakenly concluded that using CACs to bind holdouts should not trigger a CDS credit event.[96] After all, how could an amendment mecha-

94 H. Papachristou, 'Greek Collateral Deals Put Bailout at Risk – Moody's', *Reuters*, 22 August 2011, available at: <http://uk.reuters.com/article/2011/08/22/uk-greece-idUKTRE77L1IO 20110822>.

95 See, e.g., Hellenic Republic, Press Release (24 February 2012), available at: <https://www.bondcompro.com/greeceexchange/genDocuments.asp>.

96 'Restructuring through collective action clauses (CACs), which provide one means of addressing sovereign debt crises ex ante, may thus not cause a credit event if existent when the CDS was bought or the obligation issued', *Financial Times*, *Sovereign CDS Report*, at p. 42, available at: <http://www.ft.com/intl/cdsreport>. The report was not officially published, but was leaked to a Dutch newspaper in December 2010, see: <http://www.efinancialnews.com/story/2010-12-07/ec-report-clears-hedge-funds-over-greek-default>.

nism to which creditors (including would-be holdouts) had freely acceded be deemed coercive? ISDA's fall 2011 releases cleared up this technical point, using CACs as the prime example of a restructuring trigger event,[97] but did not dispel the halo of approval and implied consent around CACs.

The Greek Bondholder Act was, in form and substance, the opposite of traditional contractual CACs. It was a unilateral statutory modification of debt contracts, much as a straight-up amendment of the payment terms or a punitive withholding tax might have been. Its only connection with CACs was that it gave some bondholders some voice over what happened with the lot. But even in this respect, Greece's 'Retro-CAC' was quite unlike the contract standard: it used a lower voting threshold and applied across the aggregated Greek-law stock. In the case of Greece's English-law bonds, the amendment vote would proceed issue by issue, and individual bond issues could vote against restructuring and drop out. The combination of low voting thresholds and aggregation meant that a few big issues held by Greek banks could seal the deal for 90% of the debt in an eventual restructuring.

Here, for the first time, was an event that might fit the elusive 'binding on all' requirement of the Credit Derivatives Definitions: it was a blanket, mandatory change in the bond terms that set them up for shabby treatment by the debtor. On the other hand, the insertion of Retro-CACs did not effect principal or interest reduction but only made it easier for Greece to do it later. Greece had not yet deployed this tool, and might not need to, if merely threatening to do it would secure quasi-voluntary participation in a debt exchange. Though Greek bondholder fortunes had taken a clear turn for the worse, they did not meet the conditions for CDS protection payouts. ISDA's DC said so on 1 March 2012, even as most observers said a credit event was imminent.[98]

Was another interpretation available, one that reflected the newly vulnerable status of the Greek-law bonds relative to their English-law counterparts? Perhaps a DC might have called the insertion of Retro-CACs a subordination, a reduction in status of the bonds affected by the Greek Bondholder Act, which like the Finnish collateral incident, reduced their chances of getting paid. Such a decision might have better reflected the economics and politics of the situation. Going forward, it would have reduced the scope for debtor opportunism: a law that reduced or even

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[97] ISDA, *supra* n. 87.

[98] ISDA EMEA Determinations Committee, 'Credit Event Has Not Occurred with Respect to Recent Questions on the Hellenic Republic (Greece) Restructuring' (1 March 2012), available at: <http://www2.isda.org/greek-sovereign-cds>. See Shearman & Sterling, LLP, 'Greek Restructuring: Why Isn't it (Yet) a Credit Event', Client Publication (2 March 2012), available at: <http://www.shearman.com/files/Publication/c3d25968-9869-4979-92b4-2473f3314caa/Presentation/PublicationAttachment/8ea18e47-1b8b-4a25-9e29-a75f35b8a01a/Greek-Restructuring-Why-Isnt-It-Yet-a-Credit-Event-BR-030212.pdf>; see also F. Salmon, 'Worrying About Greece's CDS for the Wrong Reasons', *Reuters*, 2 March 2012, available at: <http://blogs.reuters.com/felix-salmon/2012/03/02/worrying-about-greeces-cds-for-the-wrong-reasons>.

eviscerated the value of the bonds without formally changing the payment terms would now have legal consequences for the CDS. After all, the only scenario in which Greece would not use its Retro-CACs to change payment terms was one where most of its creditors gave up most of what was due to them merely for fear that Retro-CACs would be used. Late 2011, ISDA releases already said that there would be no credit event in such a nominally voluntary exchange. Why not use the remaining interpretive flexibility to sanction the mandatory term change that enabled future coercion?

The incentives for derivatives counterparties would not change; they do not control the sovereign. But ISDA DCs would have to engage in a more contextual inquiry about whether retroactive legislation in fact made things worse for a sovereign's bondholders. ISDA would lose the benefit of one bright-line test (a change in payment terms), though it would keep another ('binding on all'). The advantage of better capturing the economic and political context of a sovereign debt crisis would come at a cost of more interpretive uncertainty, more work and more political pressure on ISDA at the back end of a transaction. Governments already anxious about the effect of sovereign CDS on their debt markets would lose some control over credit event triggers, and would have to look to ISDA's case-by-case judgments about the effects of their laws and regulations. Under the circumstances, it was far preferable for ISDA DCs to stick with the text, even at the cost of criticism from some powerful constituents.[99]

4.6 The ECB swap

Subordination is normally part of the Restructuring definition for corporate and sovereign CDS alike, but its operation in sovereign CDS is something of a mystery. When a corporation is liquidated in bankruptcy, its assets are distributed in the contractual and statutory order of priorities – senior debt is first, equity last; subordinated debt is in between. This order of distribution may also serve as a test of fairness for bankruptcy reorganisation, and structures incentives in out-of-court restructuring. But sovereigns cannot file for bankruptcy, are never liquidated and therefore cannot readily articulate an 'absolute priority' waterfall. To be sure, sovereigns routinely discriminate among their creditors,[100] but, with a few notable exceptions,[101] they assiduously avoid enshrining discrimination in contract or statute highlighting the gap between economic harm and a change in legal status.

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[99] 'Greek Debt Ruling Dangerous Precedent: PIMCO's Gross', *Reuters*, 1 March 2012, available at: <http://www.reuters.com/article/2012/03/01/us-greece-bonds-pimco-idUSTRE8201D920120301>.

[100] A. Gelpern, 'Building a Better Seating Chart for Sovereign Restructurings', 53 *Emory Law Review* (2004) p. 1115; A. Gelpern and B. Setser, 'Domestic and External Debt: The Doomed Quest for Equal Treatment', 35 *Georgetown Journal of International Law* (2004) p. 795.

[101] Frankel, *supra* n. 66.

For over a decade, the meaning and implications of obligation status in sovereign debt have been furiously debated in the courts and in the academic literature.[102] At the heart of the debate was a ubiquitous Latin clause (*pari passu*, or 'in equal step') that appeared to promise creditors equal treatment with similarly situated others.[103] Without a bankruptcy filing and a bankruptcy estate, there was no agreement on what it took to breach the clause. Enacting a law that used the term 'subordination' would surely do it, but no government enacted such a law in the real world. At one extreme, some debtors argued that failure to pay a subset of creditors for years, passing a law that prohibited payment to them, and disclosing in securities filings that the debt was non-payable, did not amount to subordination. At the other extreme, some creditors said that any selective non-payment was a reduction in status for those stiffed.[104] Scholars found lawyers drafting the *pari passu* clause bafflingly incapable of articulating a coherent affirmative meaning;[105] doctrinal inquiry driven by creditor interests produced a similarly indeterminate outcome.[106]

But for the CDS, this entire debate would have held little relevance for Greece, whose domestic debt had no *pari passu* covenants to uphold its legal status. Standard wording in Credit Derivatives Definitions made Subordination a Restructuring Credit Event, unless the parties bothered to exclude it. By all accounts, hardly any did.[107] Now Greece was facing a big subordination problem, bigger than Finnish collateral and the purported effects of its Retro-CAC law.

About a quarter of the total debt stock Greece had sought to restructure was held by the European Central Bank (ECB) and other European central banks, which had come to hold it as a result of crisis response programmes launched in May 2010 and

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[102] See, e.g., W.W. Bratton, '*Pari Passu* and a Distressed Sovereign's Rational Choices', 53 *Emory Law Journal* (2004) p. 823; L.C. Buchheit and J.S. Pam, 'The *Pari Passu* Clause in Sovereign Debt Instruments', 53 *Emory Law Journal* (2004) p. 869, at pp. 911-917; M. Weidemaier, R. Scott and M. Gulati, 'Origin Myths, Contracts, and the Hunt for *Pari Passu*', *Law & Social Inquiry* (forthcoming), available at: <http://ssrn.com/abstract=1633439>; Frankel, *supra* n. 66.

[103] A clause might say, for example, 'These obligations shall rank at all times *pari passu* with all other unsecured unsubordinated external indebtedness of the issuer.'

[104] Hearing Transcript, *NML Capital Ltd.* v. *Argentina*, No. 12-105 (2d Circuit, 23 July, 2012).

[105] Weidemaier, et al., *supra* n. 102.

[106] Bratton, *supra* n. 102.

[107] We see the reason is something of a puzzle, though we suspect that it might have something to do with the fact that including subordination was a strong default option: unless the market standard shifted, parties that excluded subordination would suffer a liquidity penalty. Apart from network effects, few protection buyers would give up protection against subordination, even if it were rare; and just as few protection sellers would fight against including it, especially if it were rare. Besides, the debate on *pari passu* clauses in sovereign debt documentation was complex and parochial, confined to relatively narrow emerging market sovereign debt circles.

other monetary and liquidity provision operations. The ECB took the view, accepted by the European leadership, that restructuring central banks' Greek debt holdings would be tantamount to printing money in contravention of its Charter and European Treaties.[108] To spare ECB and the Eurosystem the fate of its other bondholders, in February 2012 Greece swapped central bank-held bonds for new ones identical to the old in every respect, except identification numbers. Having thus segregated central bank holdings from the rest, Greece would omit the new identification numbers from the list of instruments invited – or bound – to take a haircut.[109] At the same time, Greece exempted the new bonds from the 'Retro-CAC' law discussed in the preceding section. Did this contractual and legislative manoeuvre to separate one set of bonds from the rest, for the stated purpose of preferential treatment, count as Subordination under Greek CDS?

After the ECB swap in February 2012, this question came before ISDA's DC. Within days, the DC decided unanimously that no subordination, and therefore no credit event had occurred within the meaning of ISDA 2003 Credit Derivatives Definitions.[110] Although the DC did not elaborate the grounds of its decision, ISDA pronouncements before and after the decision shed some light on its logic. Just as with the 'Retro-CAC' law, laying the groundwork for treating different obligations differently did not amount to differential treatment. No one had changed payment terms or missed a payment – yet.

As in the case of 'Retro-CACs', the argument against triggering a credit event here is defensible. On paper, ECB and private bonds were different but equal. On the other hand, no one with even a passing knowledge of the situation had any doubt that the only rationale for the ECB swap was to treat its bonds better than those held by private creditors. Bloomberg's 'Breaking News' segment announcing the ISDA decision highlighted the irony: 'Last week Greece exchanged bonds with the ECB, giving the ECB seniority over others; it would not force the ECB to take losses. Somebody complained, took it to ISDA, and ISDA said, 'No credit event.'[111] The report did not take issue with ISDA's decision; instead, commentators observed that there was still time to trigger a credit event if and when someone did not get paid. But 'Failure to Pay' is a credit event distinct from Subordination. If, in fact, ECB had been given 'seniority,' waiting until non-payment would have made the Subordination trigger superfluous.

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[108] European Central Bank, M. Draghi and V. Constâncio, Introductory Statement to the Press Conference (with Q&A) (9 February 2012), available at: <http://www.ecb.int/press/pressconf/2012/html/is120209.en.html>.

[109] See J. Cotterill, 'ECB Seniority and Dirty Hands', *Financial Times Alphaville*, 7 February 2012, available at: <http://ftalphaville.ft.com/blog/2012/02/17/886061/ecb-seniority-and-dirty-hands>.

[110] ISDA EMEA Determinations Committee, *supra* n. 98.

[111] Bloomberg TV, 'No Payout on Greece Default Swaps, ISDA Says,' 1 March 2012, available at <http://www.bloomberg.com/video/87459768-no-payout-on-greece-default-swaps-isda-says.html>.

Even in the murky world of sovereign priorities, it did not take a big contextual leap to conclude that creating a formally different class of debt for the publicly stated purpose of treating it better than the others, was effective subordination. It was not Subordination under ISDA's Credit Derivatives Definitions. After the ISDA DC decision, the requirements for triggering a Subordination Credit Event remained as mysterious as the meaning of the *pari passu* clause.

4.7 **'Magic is might'**

In the end, CDS protection buyers got lucky. Greece decided against using the leverage it had under local law to debase its bonds, and chose instead to use its statutory 'Retro-CACs' to amend the payment terms. Once the law was deployed, it bound the holders of over €177 billion in Greek bonds with the vote of just over €146 billion. At last, a Restructuring Credit Event was nigh – and ISDA's DC agreed.[112] Why Greece chose this route is still unclear. Perhaps it wanted the benefit of what legitimacy it could get from a CAC-style voting procedure with its rhetorical affinity to market practice. It is also possible that market pressure to allow the triggering of Greek CDS played a role, though anecdotal reports from those involved in the restructuring deny any such role.

Once the decision to declare a credit event was made, ISDA was careful to collect formal evidence of the trigger. It took the position that the restructuring was not 'binding on all' until the Greek Cabinet had decided to use the 'Retro-CACs', the Bank of Greece announced the decision, and the decision was published in the Official Gazette. Because it took all day to publish the Greek government decision, the market spent several tense hours wondering whether the credit event would be called at all.[113]

After the long-awaited credit event came to pass, the Greek CDS drama was far from over. Greek CDS holders now had to ensure that ISDA's auction settlement mechanism, established with the Big Bang in 2009, would in fact compensate them for the reduction in the value of the underlying bonds. In theory, a CDS contract should pay the protection buyer the difference between the face value of the underlying bond and the recovery value on that bond after the restructuring. For example, if the old Greek bonds are worth 20% of their face value thanks to a credit event, then the holders of Greek CDS should be paid 80% of that face value. The sum of what they recover on the old bond and receive from their protection seller should, in theory, come to 100%.

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[112] ISDA EMEA Determinations Committee, 'Restructuring Credit Event Has Occurred with Respect to The Hellenic Republic (Greece)' (9 March 2012), available at: <http://www2.isda.org/greek-sovereign-cds>.

[113] Bloomberg TV, 'ISDA's Geen Says CDS Triggers Are Predefined, Technical,' 12 March 2012, available at: <http://www.bloomberg.com/video/88138880-isda-s-geen-says-cds-triggers-are-predefined-technical.html>.

Before auctions, CDS protection buyers would have to find defaulted bonds and deliver them to their protection sellers in exchange for payments equal to the full face value of the bonds. That way, the protection buyer got 100% and the protection seller took the loss on the bond. But because the amount of outstanding CDS need not match the amount of underlying debt, in some cases, a large number of CDS holders ended up chasing a small number of defaulted bonds, causing an artificial spike in their price. ISDA's auction process was, in part, a response to this problem. A centralised auction maximises available liquidity in the defaulted bonds and helps establish their market price. Once the price was set, CDS counterparties could simply net their financial obligations; there was no need to find defaulted bonds.

ISDA's auction process assumed two background facts that did not hold in the Greek case and would not hold in many sovereign debt restructurings. First, it counted on default or amendment of the old bonds, which would remain available for delivery in the auction. In the Greek case, as in most sovereign restructurings, the measure 'binding on all' forced an exchange of the old bonds for new ones and the simultaneous cancellation of virtually all the old bonds. If Greece emerged with a sustainable debt burden, the new bonds would trade at a much higher fraction of their face value. Second, the auction mechanism was based on the assumption that the credit event would yield a single defaulted or amended obligation of the same issuer (here, Greece). However, from the dawn of modern sovereign restructuring practice in the 1980s, sovereigns have offered their creditors menus and packages of instruments to suit their economic, regulatory and accounting needs and thereby maximise participation in the debt exchange.[114] In the 1980s and 1990s, and again in Greece in 2012, part of the creditors' exit package might include instruments of other issuers, usually highly rated obligations such as the United States Treasury debt. Sovereign restructuring packages have also included contingent instruments, which might not have value at the outset but could deliver substantial payments if they were indexed to the debtor's economic growth or the price of oil. Contingent instruments give the creditors something analogous to an equity stake in the sovereign's economic performance.

Greece offered its creditors a combination of new Greek bonds, now governed by English law and containing a full complement of covenant protections, bonds issued by the European Financial Stability Facility (backed by Europe's most creditworthy governments), and instruments linked to Greece's economic output. Compensating Greek CDS holders for actual reduction in the value of the old Greek bonds would require establishing the value of this exit package as a percentage of the face value of the old bonds. But ISDA's auction mechanism had no way of valuing the total package and, notably, no way of reflecting bonds issued by anyone other than Greece in the payout calculation.

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[114] Cline, *supra* n. 85.

Two potentially perverse scenarios became immediately apparent: first, where wiping out the old bonds freed up debtor resources and made the new bonds so valuable that an auction would dramatically under-compensate the old bond holders; second, where the new bonds formed only a small part of the exchange package, but were alone eligible to tender in the auction, resulting in dramatic over-compensation of the old bond holders.[115] Neither of the perverse scenarios came about in Greece. An auction on 19 March brought about a payout just under 80%, roughly in line with the losses on the old Greek bonds.

A confluence of odd facts helped bring about this outcome. First, even after deep haircuts on the old bonds, Greek debt remained patently unsustainable, and traded at a big discount. Second, even though this discount might have been insufficient in itself to ensure adequate payout, the fact that the new bonds formed only a portion of the exchange proceeds further increased the payout. No doubt the ISDA DC members charged with compiling a list of deliverable obligations in the Greek settlement were keenly aware of the imperative to approximate the actual losses on the old bonds.[116] However, ISDA specifically rejected appeals to construe deliverable obligations

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[115] The following hypotheticals illustrate the challenge embedded in the assumptions that the old impaired obligation still exists and that a Restructuring Credit Event produces a single exit instrument:

– Assume that Greece used CACs to reduce the face value of its bonds by 75 per cent. Let us also assume that the new bonds were now certain to repay in full thanks to the combination of deep debt reduction, new contractual protections and the choice of English law to govern the instruments. The market value of a new €1000 Greek bond would be its face value, or €1000. Because it is the only Greek bond available, it would be 'cheapest to deliver' into CDS settlement. But delivering a new bond would produce net zero payout. The new bonds would be valuable precisely because the old bonds had been wiped out; however, if the old bonds were all tendered in the exchange and cancelled by the debtor, they would not be around to value in the auction or tender in the settlement.
– Suppose instead that Greece exchanged its old bonds for a package of new English-law Greek bonds (trading at 40 cents on the euro of their new face value), EFSF bonds (trading at 99 cents on the euro) and GDP warrants (current value unknown). For simplicity, assume that each bondholder got the same package, valued in the aggregate at 50 cents on the euro of the old bonds – leaving a loss of 50 cents to be made up by the CDS payout. But if the only instrument eligible for tender in the settlement auction were the new Greek bond trading at 40 cents on the euro, CDS protection sellers would have to pay 60 cents, and participants in the exchange would get a windfall in the form of the EFSF bonds and the GDP warrants.

See, e.g., F. Salmon, 'How Greece's Default Could Kill the Sovereign CDS Market', *Reuters*, 29 February 2012, available at: <http://blogs.reuters.com/felix-salmon/2012/02/29/how-greeces-default-could-kill-the-sovereign-cds-market>; 'The Auction Problem' (7 April 2012), available at: <http://www.breakingviews.com/the-auction-problem/21009343.article>.

[116] A note to the DC decision on deliverable obligations is revealing: the Committee acknowledges having considered and rejected the possibility of counting the entire restructuring package towards CDS settlement. The decision might have been different if including more instruments were the only way to reflect actual losses. ISDA, DC Decision (19 March 2012), available at: <http://www.isda.org/dc/docs/EMEA_Determinations_Committee_Decision_1303 2012.pdf>.

broadly to track the economics of the Greek exchange. DC members' skill and the fact that they had enough bonds to work with to produce the right number in the end, as if by magic, should not obscure the fact that they reached this result by going the wrong way.

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In this section, we have offered a description of the events leading up to the trigger and settlement of credit default swaps in the Greek debt crisis. Our purpose is not to contest ISDA's interpretations of its contracts, which were defensible, nor to propose reform, which others have done.[117] We might go further than others to exclude the Subordination credit event from sovereign CDS, or, if it were to remain, to include an event based on the granting of collateral, to parallel negative pledge safeguards. It may be worth considering whether a credible threat of default in the context of a sovereign debt exchange might, under some circumstances, constitute Repudiation of the holdout debt, and whether some exit amendments that do not change payment terms should qualify as Restructuring, if binding on all.[118] But that is not our preoccupation.

Instead, we find this case study interesting for what it reveals about the institutional and political imperatives of financial contract interpretation. For nearly a year, perhaps more, ISDA had been caught between a market that looked to it to ensure the viability of sovereign CDS, and governments that saw these instruments as a threat and seemed determined to undermine them. If the market survived, it would emerge heavily regulated – much more heavily if the Greek crisis had brought about widespread disruption, and CDS got the blame. Some market participants said, and others implied, that the mix of political risk and legal uncertainty made sovereign CDS more trouble than they were worth. Despite the funding and liquidity advantages of CDS over bonds, these players simply got out.[119] To stem the exodus, CDS contracts had to trigger, but prove non-threatening

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117 See e.g., D. Duffie and M. Thukral, 'Fixing the Flaw in Sovereign CDSs', *Risk Magazine*, 4 July 2012, available at: <http://www.risk.net/risk-magazine/opinion/2186966/fixing-flaw-sovereign-cdss>. M. Leising, 'Stanford Credit-Swap Revamp Seeks to Fix Flaw in Payouts', *Bloomberg*, 7 May 2012, available at: <http://www.bloomberg.com/news/2012-05-07/stanford-credit-swap-revamp-seeks-to-correct-flaw-in-payouts-2-.html>.

118 See *supra* n. 89; L.C. Buchheit and G.M. Gulati, 'Exit Consents in Sovereign Bond Exchanges', 48 *UCLA Law Review* (2000) p. 59. For a discussion of especially punitive exit amendments in the non-sovereign context, see *Assénagon Asset Management S.A.* v. *Irish Bank Resolution Corporation Limited* (formerly Anglo Irish Bank Corporation Limited) [2012] EWHC 2090. In this case, the amendments effectively changed the payment terms. A Restructuring credit event was triggered. ISDA Determinations Committee, 'Anglo Irish a Restructuring Credit Event' (24 November 2010), available at: <http://www2.isda.org/attachment/MjQ3Mw=/press112410.html>.

119 See, e.g., Bloomberg TV, 'Greek CDS "Technical Issue" Humes Says', 9 March 2012, available at <http://www.bloomberg.com/video/88078794-greek-credit-event-is-technical-issue-humes-says.html>.

to the European governments. This required government cooperation and a strategic approach to contract interpretation. At every fork in the road, ISDA made a choice that helped achieve this result. The instrument that triggered in the end protected CDS buyers in the narrowest set of sovereign distress scenarios, was prone to manipulation by the debtor and its official backers, and paid out in little logical relation to actual losses. Other choices were available along the way. In conclusion, we consider the implications of ISDA's choices in more depth and against the background of what we know about the broader universe of commercial contracts.

5. CONCLUSIONS

ISDA explains its CDS adjudication model by reference to its expertise and sensitivity to market context, particularly the economics of credit transfer. But in the biggest test to date for the sovereign CDS contracts, ISDA consistently and expressly emphasised fidelity to contract text as distinct from economic substance of the transaction. It even issued pre-emptive rulings explaining the difference between economic and legal outcomes under its contracts. At first blush, this seems puzzling. Why take adjudication private if the goal is to promote reflexive fidelity to bright-line rules, apparently made brighter at every drafting opportunity? And what is the use of technical expertise and contextual knowledge in such an adjudication environment?

To answer these questions, we experiment with putting aside the contract as an object and unit of analysis. Instead of asking how to make the sovereign CDS contract better – more just or more efficient – through drafting, interpretation and enforcement, we ask what work it does for the various actors in our story. We offer preliminary thoughts on why we might expect a preference for textualist interpretation in sovereign CDS contracts. We next consider whether sovereign CDS contracts are unique, or part of a broader category of contracts that lend themselves to similar political analysis.

5.1 What contracts do for the parties

For dealers and end-users alike, the ISDA contract suite provides the essential infrastructure for the derivatives market. It frames relationships among market participants, supplies the common language in which they interact, and separates derivatives from other financial contracts, which are subject to bankruptcy and heavy regulatory oversight. Narrowing the scope for interpretation and stripping out context in most individual instruments, including sovereign CDS, should make them more easily tradable (like money, or a negotiable instrument). More, faster trading should help repeat players; more liquidity in turn should make for more efficient pricing for all market participants; the result is a bigger, faster derivatives market. Formal consistency and acontextual interpretation also support the global reach of the derivatives market, where participants trade 'as if' instruments and institutions reflected shared understanding.[120] In sum, we would expect CDS market participants as a group to favour adherence to contract text, although any given party to an individual contract might prefer the interpretive strategy that maximises its gains and minimises its losses in the case at hand.

This hypothesis has an important caveat. If market participants see ISDA and its DCs as expert, unbiased and committed to producing a stream of consistent rulings for a robust CDS market, their preference for strict adherence to the text may weaken. Traders who delegate interpretation to ISDA at the time of their contract can trade in the knowledge that their contracts will be interpreted in a predictable fashion to reflect the economics of the instrument; this should support market liquidity. The choice between text and context is secondary to the choice of ISDA DCs as the forum for important interpretation decisions.[121] Contextualism might even be preferable to reduce the risk of trigger manipulation by the sovereign debtor.

Governments are ambivalent about sovereign CDS. Those whose debt is referenced in the CDS contracts may view them as a source of market liquidity or destructive speculation. CDS offer potential debt buyers a hedging vehicle, which should attract more buyers. On the other hand, they also give market participants more ways to express pessimism about a credit, which can exacerbate a downward price spiral where CDS volumes are substantial. In a debt restructuring, CDS contracts can be a help or a hindrance. This is because the existence and size of the sovereign CDS market can alter the composition of the sovereign's creditor body and the creditors' restructuring incentives. Creditors who bought CDS protection might favour a clear-cut credit event that would bring them full payout, instead of the customary informal workout to avoid default. On the other hand, they might be willing to agree to deeper restructuring: their protection sellers would absorb the losses, but do not have a seat at the table until after the CDS trigger.

For the governments whose financial institutions participate in the CDS market (often also the governments facing debt distress), ISDA contracts and market infrastructure networks can be the source of – or a safeguard against – the spillover effects of a sovereign debt crisis. Triggering CDS can bankrupt the firms that sold protection, and cause knock-on effects from their failure; on the other hand, it can also shift losses to institutions best able to bear them.

Having ISDA as an informal intermediary can be valuable to governments in all the situations just described.[122] ISDA can help limit overall economic damage from crisis and contagion by fixing an interpretation of its contracts across the market.

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[120] Riles, *supra* n. 34. On the other hand, the regional organisation of ISDA DCs suggests a more contextualist bend.

[121] Scott and Triantis, *supra* n. 62.

[122] For an example beyond our case study of the Greek crisis, see *supra* n. 88 (ISDA's collaboration with the Japanese government to facilitate bank restructuring).

Any given market-wide interpretation might impose costs on some parties and might fail to reflect some private understandings; however, it would reduce uncertainty and could be crafted to minimise aggregate losses. A favourable market-wide interpretation of certain derivatives contracts could, for example, prevent the failure of multiple banks and save governments from bailing them out. Similarly, it could relieve pressure on exchange rates and interest rates, and thereby support economic recovery.

By definition, sovereign CDS only raise questions of interpretation in crisis. Governments in crisis care about the economic impact of ISDA contract interpretation, but not how ISDA gets there. The choice between textualist and contextualist strategies as such is of no concern to governments at the time they are most focused on interpretation: they just want their currencies to stabilise and their banks to survive. In economically and politically significant cases such as Greece, where influential governments care about the outcome, we might expect ISDA to come under enormous pressure to get the 'right result' by any means necessary. Under the circumstances, is there any reason to believe that ISDA would gravitate to textualist interpretations?

For ISDA, the contract is its power base. Interpretive error, counterparty failure and trading disruptions on a large scale threaten the continued existence of the market and ISDA's central role in it. They could also bring on government regulation, which ISDA has successfully avoided for decades. Taking interpretation to the DCs consolidated ISDA's control over the transaction cycle and the market in which it takes place. But as we noted earlier, once adjudication is private, textualism is not the obvious path. For example, contract counterparties might prefer a contextual inquiry into the economics of Greece's deal with the European Central Bank, so long as they are convinced the adjudicator is consistent and unbiased.

But it is far from clear that ISDA and the DCs at the time of the Greek crisis enjoyed the level of trust that would allow them to engage in contextual inquiry. The DC process was established barely a year before the crisis struck. Before the DCs, market participants might have feared uninformed contextualism on the part of the public judiciary. After inexpert courts had given way to expert derivatives traders, market participants had more reason to fear conflicts of interests and self-dealing on the part of DC members. In fact, rumours of such conflicts ran rampant throughout the Greek saga. The combination of near-mandatory recourse to the DCs, and discretion and contextual inquiry on the part of DC adjudicators, was politically fraught. If DC members found themselves facing bias, self-dealing and abuse of power charges at every turn, industry members might refuse to serve, imploding the mechanism and sending ISDA's contracts back to the public judiciary. At this stage, the DC process would benefit from a simple, transparent reading of the contracts readily accessible to market participants. So long as the economics were defensible, relying on a combination of plain text and publicly available, verifiable facts – such as formal pronouncements by the Greek government closely tracking the contract text – would help reassure the market and bolster the credibility of the DCs.

Above all, the Greek crisis was a test of ISDA's contracts. Producing reasonably complete contracts that work, including in times of stress, is ISDA's core competence and the original rationale for its existence. The DCs can do some of the completion work, but the onus is on drafting. The last big sovereign debt crisis (Argentina) prompted ISDA to rewrite the Credit Derivatives Definitions after the public judiciary found them ambiguous. Because it was a much bigger economy and implicated a reserve currency, Greece was a bigger test. Here too, the idea that the contracts worked, and that ISDA was not just bending to political pressure, required constituent buy-in. If making the text work required importing a whole lot of context, including hard-to-verify facts of the Finnish collateral deal, veiled threats by the sovereign and regulatory moral suasion, the contract would look incomplete and ambiguous again. Against this background, it is perhaps no surprise that ISDA representatives were at pains to describe the 'legal meaning' of the contracts as certain and plain to all – as distinct from the messy debates about transaction economics and Greek debt sustainability.[123] DC decisions had to be about contract words and government formalities, both visible to their lay audience, even if lawyers have long known these to be manipulable.[124]

In sum, there are several reasons why we might expect ISDA to prefer textualist interpretation strategies in the Greek crisis. First, minimising recourse to context can support CDS market liquidity. Second, while having an expert, impartial adjudicator can mitigate the risks from contextual interpretation without hurting market liquidity, neither ISDA's DC process nor its sovereign CDS contracts seemed to have the requisite legitimacy to support heavily recourse to context. Textualist interpretation helped ISDA and its DCs 'render account'[125] of their process to boost confidence in both drafting and interpretation. Third, European governments in 2010-2012 preferred an interpretation of CDS credit events that minimised the incidence and amount of payouts, and therefore the systemic effect of the crisis. This too argued for textualist reading in this case. However, it does not follow that this interpretive strategy must prevail in all cases. At another time, political pressure to deliver a particular outcome to satisfy governments or powerful constituents could trump other factors and support a contextualist turn. The task for future research is to identify the political and institutional factors that militate in favour of any given strategy, taking the analysis beyond party incentives and the transactional context.

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123 Bloomberg TV, *supra* n. 113.

124 See D. Kennedy, 'Form and Substance in Private Law Adjudication', 89 *Harvard Law Review* (1976) p. 1685.

125 J. Black, 'Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes', 2 *Regulation and Governance* (2008) p. 137.

5.2 The politics of interpreting financial contracts

It remains for us to consider whether our story is a fluke, reflecting a confluence of political, legal and economic factors unlikely to repeat, which therefore holds no interest for the broader study of contracts. We do not think so.

We have described a category of contracts whose interpretation has economic and political significance apart from their meaning for any given party. Writing about contracts traditionally locates politics in the contest between weak and strong parties, with the judiciary choosing sides. We follow the scholarship on business contracts to describe relationships where at least in theory both sides are sophisticated, and neither is in need of state protection. The political import of CDS and other derivatives contracts is in their systemic character: they are ubiquitous, highly standardised, and interconnected with many parts of the national and global economies. Others in this category might include common forms of wholesale financing (for example, ‘repo’ agreements), contracts that incorporate widely used indices (such as gold or LIBOR),[126] and mortgage securitisation contracts. Their interpretation can cause economic dislocation, affecting financial stability and public finances.

Where contracts play such a public role, the concern is not their effect on the parties, but on the economy as a whole. Economic policy and politics will figure prominently in contract interpretation. Analysing these contracts in the traditional terms of transactional efficiency or fairness would miss the big picture and the elephant in the room. Our reading of ISDA contracts in the Greek crisis suggests the need to study contract drafting, interpretation and adjudication as broader institutional and political phenomena. We would not expect textualism to be the preferred strategy in each case. However, we would ask about the role of contracts in mediating industry power dynamics, interest group politics and market participants’ interactions with the state, to help explain the approach to interpretation.

Defending its market against government regulation has long been a core part of ISDA’s mission. This task became urgent in the wake of the financial crises beginning in 2007, as more intrusive regulation became inevitable. To preserve its market, and retain control over it, ISDA had to perform a delicate dance: it had to assure governments that CDS would not threaten financial stability, even as it had to assure market participants that their instruments would pay out according to their terms, come what may. Against this background, textualism had several political uses. It signalled to the regulators that ISDA and its DCs could exercise tight control over a rapidly growing and politically sensitive market. It told the market

126 A. Gelpern, ‘Financial Crisis Containment’, 41 *Connecticut Law Review* (2009) p. 1051; S. Schaefer Muñoz, ‘Barclays Notes Suggest Government Pressure on Libor’, *Wall Street Journal*, 4 July 2012.

participants that their contracts worked, but also that they were technically complex and required special expertise and institutional infrastructure, which only ISDA could marshal. It demonstrated that ISDA DCs could produce impartial, consistent, and verifiable rulings for their market constituents. It also showed them that ISDA could keep governments at bay, despite officials' threats to the contrary. On the cost side of the ledger, the sovereign CDS instrument emerging from the Greek crisis does little by way of risk transfer. But if sticking to the text created a space for ISDA and its market to regroup, sovereign CDS zombies may be poised for a comeback.